THE MODERNISATION OF TRUSTEES' INVESTMENT FUNCTIONS IN SOUTH AFRICAN LAW THROUGH THE IMPLEMENTATION OF AN INVESTMENT RULE BASED ON MODERN PORTFOLIO THEORY

WIAAN VAN TONDER

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DECLARATION

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OPSOMMING

Veranderinge in beleggingsbestuur en vooruitgang in die ekonomiese en finansiële veld het tot omvattende hervorming van trustbeleggingsreg in New York, die Verenigde Koninkryk en Nieu-Seeland gelei. Die kern van hierdie hervorming is moderne portefeulje teorie ("MPT"). Tans word die wyse waarop trustees in elkeen van hierdie jurisduksies kan belê, beheer deur 'n reël wat op MPT gebaseer is. In teenstelling hiermee, het die Suid-Afrikaanse trustreg nie op hoogte van kontemporêre veranderinge in trustbeleggingsreg gebly nie en gevolglik word trustees in Suid-Afrika nie ingevolge 'n beleggingsreël gebaseer op MPT beoordeel nie.

Die oogmerk van hierdie proefskrif is om te ondersoek of trustees se beleggingsfunksies in die Suid-Afrikaanse reg deur die implementering van 'n beleggingsreël gebaseer op MPT gemoderniseer moet word. Om hierdie oogmerk te bereik, analiseer die proefskrif trustees se beleggingstandaarde in Suid-Afrika, verduidelik dit MPT en vergelyk dit die teoretiese onderbou van trustbeleggingsreg soos dit in Suid-Afrika van toepassing is *vis-à-vis* die drie bogenoemde buitelandse jurisduksies.

Die proefskrif bevind dat trustees en begunstigdes groot voordeel uit die modernisering van trustees se beleggingsfunksies kan trek en verskaf dan aanbevelings vir regshervorming in dié verband.

ABSTRACT

Changes in investment management and advances in economics and finance have led to extensive reform of trust investment law in New York, the United Kingdom and New Zealand. The centrepiece of this reform is modern portfolio theory ("MPT"). Today, trustee investing in each of these jurisdictions is governed by an investment rule based on MPT. In contrast, South African trust law has not kept abreast of contemporary changes to trust investment law and, consequently, trustees in South Africa are not judged by an investment rule based on MPT.

The purpose of this dissertation is to examine whether trustees' investment functions in South African law should be modernised through the implementation of an investment rule based on MPT. To this end, the dissertation analyses the development of trustees' investment standards in South Africa, explains MPT, and compares the theoretical underpinnings of trust investment law as applicable in South Africa *vis-à-vis* the three foreign jurisdictions mentioned above.

The dissertation concludes that trustees and beneficiaries can benefit greatly from modernising trustees' investment functions and proffers recommendations for reform.

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CHAPTER 1 – INTRODUCTION

1 Introduction and chapter overview

This dissertation offers a comparative analysis of the theoretical underpinnings of trust investment law as applicable in South Africa *vis-à-vis* three other legal jurisdictions, namely the state of New York ("New York"), the United Kingdom (specifically England), and New Zealand, with a particular focus on the integration of the principles of modern portfolio theory (hereafter referred to as "MPT") into trust law.

The following elements will be discussed briefly in this introductory chapter:

(a) the terminology used in the dissertation;

(b) the context of the main research questions;

(c) the issues to be examined in the chapters that follow;

(d) the reasons for choosing the three foreign jurisdictions used in the dissertation; and

(e) the research methodology.

2 Terminology used in the dissertation

With regard to the terminology used, the following should be noted: in the South African context, the word "founder" is used while in the foreign context, the word "settlor" is used; reference is made to "trustees" rather than "a trustee", the assumption being that founders usually select both a family member and an independent trustee to act as trustees; "trustees' investment functions" refers to trustees' investment duties and powers; the term "trust property" is used interchangeably with "trust assets"; and the words "shares", "stocks" and "equities" are used interchangeably since these words basically have the same meaning and any real distinction between them is pretty blurred. Also note that the male gender is used for references to natural persons unless it is clear from the context that a female is concerned.

3 Context of the main research questions

A trust can be described as an arrangement through which the ownership in property of one person (the founder) is transferred to other persons (the trustees) during the founder's lifetime (an *inter vivos* trust) or on the founder's death (a testamentary trust) to be administered for the benefit of certain individuals (the beneficiaries) or for a specified purpose.[1]

This is similar to what is described in South African law as a trust in the strict or narrow sense.[2] A common example of a trust in the strict sense is a private or family trust – the focus of this research. A private trust is a trust established by an individual for the benefit of beneficiaries who may include himself and his family members. At the most basic level, the principal objective of a private trust is to provide income to income beneficiaries and to protect and preserve capital for capital beneficiaries.[3]

Typical trust assets in a private trust include: cash, bonds, properties, shares on a stock exchange, and shares in a private family company. Considering that shares in a family company sometimes form part of the assets of a trust, it is clear that private trusts can have certain business features.[4] But this does not make it a "business trust" – it remains a private trust. A trust is regarded as a business trust if it has as principal objective the carrying on of business for profit.[5] This type of trust, however, falls outside the scope of this dissertation.

Almost every private trust requires of trustees to make an investment.[6] For trustees, the question becomes how best to invest trust assets not only to safeguard it from loss, but also to meet the needs of trust beneficiaries. Taking the wishes of

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[1] See E Cameron, M de Waal, B Wunsh, P Solomon & E Kahn *Honoré's South African Law of Trusts* 5 ed (2002) 4; MJ de Waal "The core elements of the trust: aspects of the English, Scottish and South African Trusts compared" (2000) 117 *SALJ* 548 549 footnote 10; and MJ de Waal "Is the DCFR trust a 'proper' trust? An evaluation from a South African perspective" (2014) *Acta Juridica* 221-223 and 229. The South African *bewind* trust should be distinguished. In a *bewind* trust ownership of property is transferred to the beneficiaries, but control over it is given to the trustees. Such a trust is rarely used in practice: De Waal (2000) *SALJ* 561. The *bewind* trust does not form part of the research.

[2] See Cameron et al *Honoré's Law of Trusts* 4.

[3] B Wunsh "Trading and business trusts" (1986) 103 *SALJ* 561 561.

[4] 561.

[5] F du Toit, B Smith & A van der Linde *Fundamentals of South African Trust Law* (2018) 200; Wunsh (1986) *SALJ* 561.

[6] LOC Chukwu "Theoretical underpinnings of trust investment law: juxtaposing Nigerian law with current trends in other Common Law jurisdictions" (2017) 22 *Ann Surv Int'l & Comp L* 73 73.

the trust founder into account, trustees are expected to determine which investment vehicles to choose and how much of the trust's assets to invest in each vehicle.[7] This is not an easy task seeing that investment management has changed significantly over the past 50 years and has become more complicated and sophisticated – both from an academic and a practical point of view. Nowadays all investors, be they trustees, private individuals or professional investors, are faced with an extraordinary range of investment products and techniques when it comes to building and maintaining an investment portfolio.

These changes in investment management and advances in economics and finance have led to extensive reform of trust investment law in New York, England and New Zealand. The centrepiece of this reform is MPT. In its simplest form, MPT is a theory of investment that "attempts to maximise portfolio expected return for a given amount of portfolio risk, or equivalently minimise risk for a given level of expected return, by carefully choosing the proportions of various assets".[8] Today, trustee investing in each of these jurisdictions is governed by an investment rule based on MPT.

In contrast, South African trust law has not kept abreast of contemporary changes to trust investment law. As will become evident in the subsequent chapter, trustees in South Africa are not judged by an investment rule based on MPT.

In light of international development, the main research questions posed for purpose of this dissertation are: first, should trustees' investment functions in South African law be modernised through the implementation of an investment rule based on MPT? Second, if the answer to the first question is yes, what should the core features of such an investment rule be? In order to answer the main research questions, the following additional and more specific questions must be answered in the course of the dissertation:

(a) Question 1: what is the principal problem that trustees face when they are unable to rely on an investment rule based on MPT?

[7] SM Penner "International investment and the prudent investor rule: the trustee's duty to consider international investment vehicles" (1995) 16 *Michigan J Int'l L* 601 602; P Collins & J Stampfli "Promises and pitfalls of total return trusts" (2001) 27 *ACTEC J* 205 205.

[8] I Omisore, M Yusuf & N Christopher "The modern portfolio theory as an investment decision tool" (2012) 4 *J Account Taxation* 19 20.

(b) Question 2: is an investment strategy based on MPT the best possible approach for people managing other people's assets?

(c) Question 3: which areas of trustee investment would be most affected by integrating MPT principles into trust law?

(d) Question 4: how should these areas of trustee investment be amended in South African trust law in order to accommodate MPT?

4 Overview of the content of the dissertation

In order to address the two main research questions and answer the four additional questions, the chapters of the dissertation are structured as follows:

4 1 Chapter 2

Chapter 2 describes and analyses the development of trustees' investment standards in South Africa. The aim of the chapter is to determine which approach currently governs trustee investing and what the key features of this approach are.

Trustee investing in South African law is either governed by a "court list" approach or some version of the "prudent man rule". A significant part of the chapter is devoted to determining which of these two approaches are currently being followed. What can be stated with absolute certainty is that South Africa, unlike the three foreign jurisdictions, has not adopted an investment rule based on MPT. The chapter establishes that trustees in South Africa are obliged to protect the real value of trust capital and to ensure that an adequate income is produced continuously. In chapter 2, this is referred to as trustees' "main investment objective". It is important to note that what is expected of trustees in this instance corresponds with the goals embodied in an investment rule based on MPT. This raises the following question: is it possible for trustees to achieve their main investment objective without being able to rely on an investment rule based on MPT? This question can only be answered by analysing the development of trustees' investment standards in the comparable foreign jurisdictions. If the answer to this question is no, it means that trustees cannot achieve their main investment objective if they are unable to rely on an investment rule based on MPT.

4 2 Chapter 3

Chapter 3 introduces and explains MPT. The chapter is not intended to give a comprehensive explanation of all the elements and aspects of the theory. Rather, the intention is to provide a basic insight into MPT in order to aid a better understanding of the issues examined in more detail in the chapters that follow.

In order to achieve this basic insight into MPT, the chapter briefly compares it to another popular investment strategy, details the development of the theory from the 1950s, and provides a summary of its major lessons.

The aim of the chapter is, first, to illustrate that the theory presents a better account of risk and safety than other popular models of investment behaviour, and second, to demonstrate that an investment strategy based on MPT is the best possible approach for people managing other people's assets.

4 3 Chapters 4, 5 and 6

Chapters 4, 5 and 6 describe and analyse the development of trustees' investment standards in New York, England and New Zealand, respectively. The aim of each chapter is twofold. First, each chapter intends to show that it is exceedingly difficult – if not impossible – to achieve trustees' main investment objective without being able to rely on an investment rule based on MPT. This is done in each chapter by discussing the main characteristics of previous approaches to trustee investing; explaining why old-fashioned approaches to trustee investing had to change; and describing the core features of the investment rule currently governing trustee investing in that jurisdiction.

Second, each chapter attempts to confirm what is stated in chapter 3, namely, that MPT is the best possible investment strategy for people managing other people's assets by showing the benefits of using MPT strategies when investing trust funds.

Chapters 4 to 6 further illustrate that while the integration of MPT principles into trust law affects many areas of trustee investment, six particular areas are affected most prominently. In each chapter, the manner in which these areas had to change in order to accommodate MPT is examined.

4 4 Chapter 7

The conclusion reached after the research undertaken in chapters 4 to 6 is that the first research question should be answered in the affirmative: trustees' investment functions in South African law should be modernised by implementing an investment rule based on MPT.

The second research question asks: what should the core features of such an investment rule be? The aim of chapter 7 is to identify and explain those features. This is done by doing a detailed examination of the six areas that are affected most prominently by the integration of MPT principles into trust law. Accordingly, chapter 7 is divided into six sections and each section discusses one of the six areas of trustee investment affected by the implementation MPT. To be more precise, each section describes in more detail how MPT affects a particular area of trustee investment; explains the current problem in South African trust law regarding that area of investment; compares the different approaches of each of the foreign jurisdictions regarding that area of investment; and recommends how legislation should change in order for MPT to be integrated fully into that particular area of trustee investment.

4 5 Chapter 8

Chapter 8 constitutes the conclusion to the dissertation. The first part of the chapter provides an overview of chapters 2 to 7 and focuses on answering the main research questions as well as the four more specific additional questions. The chapter concludes with a summary of the proposed legislative changes and recommendations for further research.

5 Jurisdictions used in the dissertation

As already mentioned, the three foreign jurisdictions chosen for purposes of the research are New York, England and New Zealand – all common law jurisdictions, meaning that they are legal systems primarily based on the English common law.

Although the South African trust has its roots in English law, it has been adapted by South African courts over the years.[9] As a consequence, the main characteristics of the South African trust share many common features with those of

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[9] *Braun v Blann & Botha NNO* 1984 2 SA 850 (A) 859E-G; see also De Waal (2000) *SALJ* 555-556.

the trusts in the three common law jurisdictions.[10] Of course, there are differences. Certainly the most fundamental difference is the concept of dual ownership, which is foreign to South African law.[11] This concept – that trustees have legal (or common law) ownership of trust property and beneficiaries have beneficial (or equitable) ownership thereof – is an essential feature of the English trust.[12] In South African law, ownership cannot be split in this fashion and trustees thus have full ownership of the trust assets.[13] This difference between English trust law and South African trust law does not, however, have any significant impact in the context of trustee investing.

The comparative study will proceed on the basis that, although there are differences between the trust in South Africa and the trusts in the three foreign jurisdictions, sufficient commonality exists that a comparison of trust investment law between the different jurisdictions is possible and that South African trust law can benefit from the developments and experiences in these jurisdictions.

The focus of this dissertation is on the development of trust investment law in the relevant jurisdictions. Space does not allow for a discussion of the history of trust law in these jurisdictions. Moreover, sketching the historical development of trust law in a jurisdiction is not considered relevant to the dissertation, since such an overview would not aid a better understanding of the issues concerning trustee investing in the subsequent chapters or contribute to answering any of the additional questions to the main research questions. It should further be noted that detailed historical accounts have already been written.[14]

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[10] See BR Hauser "United States" in A Kaplan, BR Hauser & P Ogden (eds) *Trusts in Prime Jurisdictions* 2 ed (2006) 315 315-331; De Waal (2000) *SALJ* 569-570; and New Zealand Law Commission *Review of the Law of Trusts – Introductory Issues Paper* (2010) Issues Paper 19 35-42.

[11] De Waal (2000) *SALJ* 570.

[12] E Bruwer *Settlor control and trustee liability: an analysis of English and offshore trust law with indicators for the development of South African Trust Law* LLD thesis, University of Stellenbosch (2018) 9; MJ de Waal & I du Plessis "A comparative perspective on the 'joint-action rule' in the context of business trusts" (2014) 2 *Stell LR* 343 345 footnote 12.

[13] De Waal (2000) *SALJ* 550; Bruwer *Settlor control and trustee liability* 91. Note that the concept of separation of estates is recognised in South African law. In terms of this concept, a trustee holds two separate estates: trust assets are held in the trust estate; and the trustee's personal assets are held in his private estate: De Waal (2014) *Acta Juridica* 236.

[14] For a history of trust law in the respective jurisdictions, see JP Coetzee *`n Kritiese ondersoek na die aard en inhoud van trustbegunstigdes se regte ingevolge die Suid-Afrikaanse reg* LLD thesis,

The reasons for specifically selecting New York, England and New Zealand are as follows:

5 1 New York

Authors and academics from the United States of America set the stage for the integration of MPT principles into trust law. Starting in the late 1970s, these critics – the most prominent ones being based in New York at the time – began to point out the relevancy of the lessons of MPT to trust investment practices and called for reform in trust investment law. Their observations and criticisms are quite detailed and provide a rich source of ideas for developing an investment rule based on MPT.

New York has a well-developed trust law based on English common law and a highly developed and advanced economy.[15] Due to the significant amount of trust and economic activity centred there, the law of New York is important in the development of the trust law in other states within the United States.[16] Furthermore, New York's legislative committees often produce much of the early initiative and progress in legislative analysis. For example, New York was the first state to take up the task of seriously analysing the benefits of trustees applying "total return investing" to trusts.[17]

These are the reasons why, with all the American states available to choose from, the state of New York in particular was chosen for purposes of this comparative study.

University of South Africa (2006)13-143; JH Langbein "The Contractarian basis of the law of trusts" (1995) 105 *Yale LJ* 625 625-675; New Zealand Law Commission *Introductory Issues Paper* 8-28.

[15] Other than Louisiana, the states within the United States have a history of continuing the common law tradition inherited from England, which includes English trust law: Hauser "United States" in Kaplan et al *Trusts in Prime Jurisdictions* 315 and 319.

[16] FP Manns "New Zealand trustee investing: reflecting on modern portfolio theory and the ancient distinction of principle and income" (1998) 28 *Victoria U Wellington LR* 611 628 footnote 74.

[17] RB Wolf "Estate planning with total return trusts: meeting human needs and investment goals through modern trust design" (2001) 36 *Real Prop Prob & Tr J* 169 177. For a discussion of total return investing, see chapter 4 para 4 4 4.

5 2 England

England was chosen because English trust law has had a significant influence on the development of the trust institution globally and the development of the trust figure in South Africa in particular.[18]

Furthermore, twentieth-century advances in economics and finance have led to extensive reform of England's trust investment law. After extensive research, a joint report from the English Law Commission and the Scottish Law Commission[19] led to the enactment of the Trustee Act 2000. Importantly, the definition of the standard investment criteria in the Act accords with MPT.[20]

By examining the recommendations made by the authors of the joint report of the two law commissions, the cases referred to in the report, the provisions of the Trustee Act 2000 dealing specifically with trustee investment, and how commentators and authors have interpreted and criticised these provisions, one gains valuable insights on how to address and improve the South African position.

5 3 New Zealand

Although authors and academics from the United States set the stage for the integration of MPT principles into trust law, New Zealand was the first jurisdiction to introduce MPT into trust law, even preceding enactments in New York by a few years.[21]

The New Zealand Law Commission has since reviewed trust law in New Zealand and recommended a major overhaul. The overhaul was completed on 30 July 2019 with the passing of the Trusts Act 2019.[22]

Of particular significance is that the Act makes important changes in the area of trustee investing. Importantly, none of these changes suggests a movement away from MPT-based trust investing. On the contrary, these legislative measures were designed to better facilitate the use of MPT techniques when investing trust funds.

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[18] Coetzee *`n Kritiese ondersoek na die aard en inhoud van trustbegunstigdes se regte* 10; Bruwer *Settlor control and trustee liability* 8-9 and 105.

[19] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* (1999) Law Com No 260 and Scot Law Com No 172.

[20] Note 25 of the Explanatory Notes, which accompany the Trustee Act 2000.

[21] P Panico "Trustees investment powers in international trust law" (2009) 15 *T & T* 96 99.

[22] The Act will enter into force on 30 January 2021.

Examining modern cases dealing with trustee investing, the criticism of commentators and academics of the position prior to the passing of the Trusts Act 2019, the recommendations of the New Zealand Law Commission, and the provisions of the Act dealing with trustee investment, provides valuable lessons and may aid the development of trust investment law in South Africa.

6 The research methodology

This dissertation involves comparative legal research. The dissertation is written from a South African perspective and thus the focus throughout will fall on the development of trust investment law in South Africa. However, reference will be made to the development and current state of trust investment law in three other jurisdictions, namely New York, England and New Zealand. The way in which these jurisdictions have addressed certain issues concerning trustee investing is studied with a view to providing guidance on how the South African position may be interpreted, addressed and improved.

The research will be conducted by analysing the following sources of information for each of the relevant jurisdictions:

(a) textbooks and journal articles by leading authors and academics;

(b) trust legislation, current and previous, regarding trustee investing; and

(c) relevant case law.

CHAPTER 2 – THE DEVELOPMENT OF TRUSTEES' INVESTMENT STANDARDS IN SOUTH AFRICA

1 Introduction

This chapter describes and analyses the development of trustees' investment standards in South Africa. The purpose of this chapter is to provide answers to three important questions: first, which approach governed the exercise of trustees' investment functions prior to 1998;[1] second, which approach has been governing trustee investing since 1998; and third, what are the main characteristics of the approach that governs trustee investing?

Trustee investing in our law is either governed by a "court list" approach or some version of the "prudent man rule". A significant part of the chapter is devoted to determining whether the court list approach or prudent man rule is currently being followed. What can be stated with absolute certainty is that South Africa, unlike the comparable foreign jurisdictions, has not adopted an investment rule based on modern portfolio theory ("MPT").

Answering the three questions above is important because the findings in this chapter are later compared with the approaches in New York, England and New Zealand. Studying how each of these jurisdictions has developed their own investment rules based on MPT might assist in improving the South African position.

Following this introduction, the chapter is divided into three sections, which are summarised in the conclusion at the end of the chapter. The first part of section 2 discusses relevant court cases from 1925 to 1982 dealing with trustee investing, while the second part of section 2 summarises and analyses the position in South Africa before 1998. Section 3 describes the approach that the South African Law Commission (hereafter referred to as the "Law Commission") regarded as governing trustee investing at the time of the publication of its report. The section also discusses the problem that the Law Commission identified with trustee investing and the possible solutions it considered. Section 4 begins by discussing the facts of *Administrators, Estate Richards v Nichol*[2] ("*Estate Richards*"). Next, the section explains the conclusion reached in the case regarding trustees' investment

[1] The year in which *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) was decided.

[2] 1999 1 SA 551 (SCA).

standards and highlights what is regarded as the case's most important contribution to trustee investing. Following this discussion, section 4 further presents a critique of the conclusion reached in the case and gives specific consideration as to whether the criticism is justified. The remaining part of the section briefly discusses two cases that were decided after *Estate Richards* regarding the subject of trustee investing.

2 The approach to trustee investing before 1998

2 1 Introduction

It would be difficult to make recommendations on how trust investment law in South Africa should change without adequately identifying and understanding its history and nature. Therefore, this section discusses the relevant court cases dealing with trustee investing, and provides a summary and analysis at the end of the discussion.

Before commencing the discussion, it is helpful to state briefly what some authors and academics – such as Rahman, De Mink, Balden and Rautenbach, and Smith – have written on the subject of trustee investing. The picture of the trustee investment landscape that they have constructed, can then be tested against a detailed discussion of the relevant court cases.

According to these authors, the development of trust investment law is as follows: *Sackville West v Nourse*[3] ("*Sackville West*") was the first case in South Africa to pronounce on the standard of care required of trustees when investing trust funds.[4] On the strength of the *dicta* in *Sackville West*, the courts adopted a conservative stance regarding the investment of trust funds.[5] To be more specific, the courts have for many years favoured fixed-income investments,[6] considered it proper for trustees to only invest in securities where the capital is fixed,[7] and confined the investment of

[3] 1925 AD 516.

[4] A Smith "Fiduciaries and investments in risky assets" (2000) January *DR* 35 35; see also M Kunene "Fiduciaries and their investment decision: a need for change" (2001) September *INS TAX* 1 2.

[5] L Rahman *Defining the concept "fiduciary duty" in the South African law of trusts* LLM thesis, University of Western Cape (2006) 77-78.

[6] J De Mink "The stormy waters of trustee investment" (2004) January *DR* 18 19; LE Balden & C Rautenbach "Die sorgsaamheidsplig van trustees in die uitvoer van hulle beleggingsbevoegdhede: kan ons by die Engelse trustreg leer?" (2005) 30 *TRW* 91 96.

[7] Balden & Rautenbach (2005) *TRW* 96.

trust funds to only bonds, fixed deposits, loans on mortgage bonds, and immovable property.[8] Until recently, therefore, the courts have not allowed trustees to invest on the stock market, because investing trust funds in shares would be too risky.[9]

2 2 Court cases from 1925 to 1982

2 2 1 Sackville West v Nourse

In *Sackville West*, Maximilian Sackville West ("Mr Sackville") was the beneficiary under a trust called the West Trust. The trust was created by a deed of transfer dated in 1882 of a farm called Dartington. The trustees were Temple Maynard Nourse ("Mr Nourse") and Edward Mackenzie Greene ("Mr Greene"). Mr Greene was a senior partner in the attorney's firm Bale & Greene. The court described him as the active trustee who did all the business of the trust through the agency of the firm, including attending to the trust's investments. The other trustee, Mr Nourse, did not take part in the management of the trust and was content to be a trustee "in name only". The trust deed did not contain provisions on how money should be invested. The trustees sold the farm Dartington in 1899 and, in 1903, invested a large portion of the proceeds from the sale in a first mortgage bond upon the security of a hotel premises. The loan was for five years with interest at 6% per year.[10]

Interest under the bond was paid for more or less four years, after which the mortgagor defaulted and no further interest was forthcoming.[11] The investment resulted in both a loss of capital and a considerable amount of interest.[12] The beneficiary, Mr Sackville, instituted an action to recover both the capital and interest lost from the trustees.[13] The key question that the court had to decide was whether the investment was negligent and improper.[14] The court held that the trustees had

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[8] Smith (2000) *DR* 35.

[9] De Mink (2004) *DR* 19; Rahman *Defining the concept "fiduciary duty"* 80 footnote 427; Balden & Rautenbach (2005) *TRW* 96 and 101.

[10] *West v Nourse* 1924 45 NPD 418 418-421.

[11] 420 and 428.

[12] *Sackville West v Nourse* 1925 AD 516 516.

[13] *West v Nourse* 1924 45 NPD 418 418.

[14] *Sackville West v Nourse* 1925 AD 516 519. The following aspects of the case are not material for purposes of the research and have been omitted: the defence of laches; the fact that the trust was not

acted negligently in investing the trust funds on insufficient security and had to repay the capital and the interest lost.[15]

Solomon ACJ and Kotzé JA stated that the case raised the important question of the duties of trustees in the investment of trust funds. Until that point, there had not been any judicial decision in South Africa on this question. The court thus had to determine what our law was on the subject. Since the action was based on negligence, Solomon ACJ considered the general principles of South African law in regard to liability for loss sustained through negligence. Kotzé JA, on the other hand, considered the rules of Roman law as expounded by the commentators and by the Dutch jurists in order to ascertain what the law was.[16]

2 2 1 1 The judgment of Solomon ACJ

Solomon ACJ stated that liability depends upon *culpa*; that is "the failure to observe that degree of care which a reasonable man would have observed in the circumstances".[17] One of the circumstances to be considered by trustees is that they are not dealing with their own money but with that of a trust. He stated that trustees were required to use greater care and caution when investing trust funds than in dealing with their own assets. As authority for this view, Solomon ACJ referred to the authorities referred to in the judgment of Kotzé JA. Solomon ACJ also showed that this was the position in England at the time.[18]

In *Sackville West* it was not a case of the trustees knowingly taking a risk in the investment in question. The active trustee, Mr Greene, believed the investment to be a perfectly sound one. The case rather rested on the following two grounds: first, that the said property was of insufficient value in 1903 to warrant an investment of £7 500 on the security thereof; and second, that the said property being used for hotel purposes was likely to fluctuate in value, thus constituting improper security for the

mentioned in the bond itself; the question concerning the removal of trustees from office; and the question about costs: 517 and 520.

[15] 516-517.

[16] 519 and 533.

[17] 519-520.

[18] 519-520.

investment of trust funds. It was decided that these two grounds overlapped and that it had to be treated together.[19]

In Solomon ACJ's view, the contention by Mr Sackville was not that it was negligent and improper in any circumstances whatsoever for trustees to invest trust funds upon the security of hotel property. The contention rather was that, inasmuch as the value of the land and buildings of a hotel depend to a great extent on the success of the hotel business, which is of a speculative nature, the margin between the sum advanced and the value of the security should have been significant.[20]

Solomon ACJ noted that, in this respect, the case bears some resemblance to *Learoyd v Whiteley*[21] ("*Learoyd*") in which trust funds were advanced upon the security of a brickfield.[22] In *Learoyd*, Lopes LJ found that if the investment on the security of a certain brickfield had been a smaller amount, no objection could have been taken to the character of the investment.[23] He concluded that no prudent man investing money for the benefit of himself and others would have invested such a large sum on such a hazardous security.[24]

Solomon ACJ found that the margin of security in *Sackville West* was not sufficient to justify the investment in question; therefore, the trustees did not use proper care or caution in the transaction.[25] He was not prepared to lay down any hard-and-fast rule on what the margin ought to have been, and felt it was sufficient to state only that the margin should have been substantial.[26]

2 2 1 2 The judgment of Kotzé JA

As mentioned above, in order to ascertain what the law on trustee investment was, Kotzé JA turned to both Roman and Roman–Dutch law. More specifically, how the law dealt with the duty of tutors and curators in the administration and investment of the property and funds of their wards and others whose interests and affairs have

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[19] 520-521.

[20] 521.

[21] (1887) 12 App. Cas. 727.

[22] *Sackville West v Nourse* 1925 AD 516 521. For a detailed discussion of *Learoyd v Whiteley* (1887) 12 App. Cas. 727, see chapter 5 para 2 3.

[23] *In Re Whiteley, Whiteley v Learoyd* (1886) 33 Ch. D. 347 359.

[24] 357.

[25] *Sackville West v Nourse* 1925 AD 516 525.

[26] 522.

been entrusted to their care. Kotzé JA found that the same principles that applied to a tutor in dealing with the property of his ward could be extended to other persons administering the affairs of others. Trustees, therefore, are to be included in this category.[27]

The old authorities revealed that tutors were obliged to invest the ready money of their wards. It was also said that a tutor must observe greater care in dealing with his ward's money than he does with his own, for, "while a man may act as he pleases with his own property, he is not at liberty to do so with that of his ward".[28] The standard of care to be observed is accordingly not that which an ordinary man generally observes in the management of his own affairs, but that of the prudent and careful man; or to use the technical expression of Roman law, the standard of the *bonus et diligens paterfamilias*.[29]

Kotzé JA found that the customs of the Dutch allowed tutors to invest the money of their wards in the purchase of landed property or put their money out at interest under sufficient pledges and suretyships. Certain Dutch laws authorised tutors to invest their wards' money in government obligations or put it out at interest to the treasury itself. These investments were deemed to be safe and secure.[30]

Kotzé JA also examined the practice of a tutor continuing a mercantile undertaking that the father of the ward had commenced, and carried on at the date of his death. According to Voet (as paraphrased by Kotzé JA), the correct approach was:[31]

> "…the tutor is obliged to complete the particular matters of trade or commerce, already undertaken by the deceased parent, with the object of withdrawing the ward's property as speedily as possible from the uncertain if of trade, and placing it in safety. … Nor should it be countenanced that where, e.g. a ward is only a year or two old, the tutor is to continue to carry on a commercial venture, begun by the deceased, until the ward attains majority, and in this way expose the property of the ward to such a risky undertaking and doubtful issue of trade, except where the father has so directed by his will …"

[27] 533-534.

[28] 534.

[29] 534.

[30] 534-535.

[31] 535.

According to Kotzé JA, Voet's opinion was thus that the money of the ward was not to be invested in a matter of "hazardous or uncertain nature, or involving the risk of mercantile speculation".[32] Kotzé JA concluded that the rule of our law is that "a person in a fiduciary position, like a trustee, is obliged, in dealing with and investing the money of the beneficiary, to observe due care and diligence, and not to expose it in any way to any business risks".[33]

Kotzé JA thus agreed with Solomon ACJ that, under the circumstances, the trustees were accordingly responsible for the consequent loss.

2 2 2 Colonial Banking and Trust v Estate Hughes

In *Colonial Banking and Trust v Estate Hughes*[34] ("*Estate Hughes*"), Meshach Hughes ("Mr Hughes") died in 1925 and was survived by his widow, Mary Love Hughes ("Mrs Hughes"), as well as their four children, Ernest, Rowland, Gordon, and Marjorie.[35] In his will, dated 6 January 1919, Mr Hughes bequeathed his whole estate to Mrs Hughes and Ernest as trustees in trust. The purpose of the trust was to pay Mrs Hughes the trust income so long as she remained unmarried, and on her death or her remarriage the trust capital was to be divided and paid over to the children in equal shares as soon as the youngest child reached the age of 21. The will gave the trustees full power to realise the estate, and when the assets had been realised, the trustees were required to invest the proceeds "on security of first mortgage over fixed property in South Africa and/or in the purchase of Government Stock of the Union or Great Britain".[36]

Mr Hughes' second son, Rowland, bought the farm Eureka (together with some movables on the farm) from the trustees.[37] The payment of the purchase price was secured by the passing of a bond (the "first bond") for £5 250 secured on Eureka in favour of the trustees. Rowland was unsuccessful in his farming operations and fell into arrears with the payment of the interest on the first bond.[38] The trustees

[32] 535.

[33] 535.

[34] 1932 AD 1.

[35] *Colonial Banking and Trust v Estate Hughes* 1932 AD 1 2-3.

[36] 5-6.

[37] 3.

[38] 6-7.

assumed that fresh working capital could be employed profitably on the farm.[39] Rowland accordingly, with the signed consent of the trustees, passed another mortgage bond (the "second bond") for an amount of £1 500 over the farm in favour of the Colonial Banking & Trust Company ("Colonial Banking").[40]

Soon thereafter, Rowland became hopelessly insolvent. A petition for his sequestration was signed by Mrs Hughes and Rowland's brother, Ernest, and his estate was sequestrated in August 1929.

Frederick Martin, the trustee of Rowland's insolvent estate, immediately took steps to sell Eureka so as to pay off the bonds registered against the farm. In October 1929, a deed of sale was signed between Frederick Martin in his capacity as trustee of the insolvent estate and the purchasers, namely, Russel and Hendler. The balance of the purchase price remaining after the necessary deductions was £5 620.[41]

Colonial Banking argued that the passing of the second bond ranked *pari passu* (on equal footing) with the claim of the trustees under the first bond.[42] Therefore, the purchase price of £5 620 had to be divided in the proportion of £1 230 to Colonial Banking and £4 390 to the trustees of Mr Hughes' trust.[43] This meant that the trustees could potentially suffer a loss of £860.[44] The trustees argued that the second bond did not rank *pari passu* with the first bond and that they had to be put in the position in which they were prior to giving consent.[45] The trial court found that the trustees were entitled to an order declaring the first bond to be preferent to the second bond.[46] Colonial Banking appealed to the Appellate Division.

The Appellate Division reversed the decision *a quo* on the following grounds: first, the will authorised an investment jointly with others on a *pari passu* bond. Second, taking a mortgage ranking *pari passu* with an existing mortgage was in effect an exercise of a power to invest on a *pari passu* bond. Alternatively stated, consenting to share a security *pari passu* under the circumstances was indeed an "investment"

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[39] 20.

[40] 8.

[41] 8-11.

[42] 19.

[43] 14.

[44] £5 250 (the amount of the first bond) minus £4 390.

[45] *Colonial Banking and Trust v Estate Hughes* 1932 AD 1 18.

[46] 1.

and not merely "the giving away of portion of the security of an existing investment".[47] Third, the consent of the trustees to the second bond was not only in the interest of Rowland Hughes, but in the interest of all the beneficiaries.[48] Therefore, it cannot be said that the trustees did not act in the interest of the trust estate. Stratford JA stated that:[49]

> "… it seems reasonable to suppose that the estate was very much interested in Rowland making a success of his farming operations, since he was its debtor and unable at the time to pay his rent. The trustees (Ernest was then the only active one), must have assumed that fresh working capital could and would be profitably employed on the farm."

Fourth, even if there was a breach of trust, the beneficiaries, with full knowledge of their alleged rights, had voluntarily entered into an agreement, which amounted to a confirmation of the action of the trustees.[50]

Estate Hughes is an important case since it laid down the following trust law principles: first, whether or not an investment can be said to have been prudent is a question that can only be decided on the facts of each particular case. Wessels ACJ formulated this principle as follows:[51]

> "Our law draws no hard and fast line in regard to the discretion of a fiduciary heir who is required to invest the funds of an estate on behalf both of himself and others. Every case must depend on its own circumstances. A fiduciary heir who acts under a will in the interests of the whole family has a somewhat wider discretion than a stranger who is appointed as the administrator of a fund."

Second, where a trustee is also a beneficiary, and acts in such a way as to benefit himself at the expense of the other beneficiaries, his acts will be scrutinised narrowly. Third, on the one hand, the court must see that trustees carry out their duties with scrupulous care for the benefit of the beneficiaries; yet on the other hand, the court must be careful not to "fetter too much or to punish trustees" for exercising

[47] 18-19.
[48] 15.
[49] 20.
[50] 1 and 16.
[51] 15-16.

their discretion in dealing with the investments they are required to make in a *bona fide* manner.[52]

2 2 3 Ex parte Harrington and Perry

Although *Ex parte Harrington and Perry*[53] ("*Ex parte Harrington*") is a case from Southern Rhodesia (now part of Zimbabwe), it is relevant for purposes of the research because both Cameron and others[54] and Frere-Smith[55] refer to it as authority.[56]

Thomas Edwin Speight ("Mr Speight") under his will set up two trusts, namely, "my wife's trust fund" and the "Davies trust fund". The issue raised in the case related only to the second trust. Mr Speight provided in his will that his trustees were to set aside and hold sufficient shares in gold mining companies, or as he had expressed it in his will, "gold shares", to give an annual yield of £240. He gave the following instructions as to the manner in which the Davies trust fund had to be dealt with:[57]

> "I direct my administrators to invest my wife's trust fund and Davies trust fund with power from time to time to vary the investments and to receive the income thereof. I authorise my administrators, if they think fit, to leave undisturbed any investments in the form in which they are at the time of my death and I direct that my administrators are not liable to make good to my estate any loss which may be occasioned through leaving any such investments undisturbed or through any other investments *bona fide* made by them."

The question that had to be decided was what the exact meaning of Mr Speight's directions in regard to the Davies trust fund was. In particular, did the trustees have to leave the trust's investments undisturbed or were they permitted to vary the investments? Hudson J made an order declaring that on a proper construction of the will it was clear that the trustees had the power to vary the investments in the trust

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[52] 16.

[53] 1938 SR 108.

[54] E Cameron, M de Waal & P Solomon *Honoré's South African Law of Trusts* 6 ed (2018).

[55] P Frere-Smith *Manual of South African Trust Law* (1953).

[56] See Cameron et al *Honoré's Law of Trusts* 349 and Frere-Smith *South African Trust Law* 79.

[57] *Ex parte Harrington and Perry* 1938 SR 108 109.

and invest trust capital in such a manner as they "thought fit", and that their investments did not necessarily had to be confined to gold shares.[58]

Hudson J remarked that, although gold shares were looked upon as having a fairly long period of life, there was no doubt that they tended to fluctuate occasionally. He cautioned that holding gold shares could later turn out to be not such a safe investment as the trustees first considered it to be. It was further stressed that if the interests of minor children were concerned, and the interested parties consented, he would not have allowed an investment in gold shares, but would have only permitted an investment in some other more "satisfactory form". Nevertheless, despite his view of gold shares, Hudson J did not confine the investment of trust funds to investments "suitable for a trust fund" as he called it, but left the investment of trust funds to the discretion of the trustees.[59]

2 2 4 Ex parte Executor Testamentary Estate Late Arthur Storm

In *Ex parte Executor Testamentary Estate Late Arthur Storm*[60] ("*Ex parte Storm*"), Arthur Storm ("Mr Storm) died in 1942 and was survived by his widow and their only daughter. He left amongst his assets shares in a company called The Coronation Brick and Tile Company (the "Coronation Company") in trust.[61] In his will, he directed his trustee to invest in "recognised trust securities":[62]

> "The whole of the remainder of my Estate I direct my Trustee to hold and administer as hereinafter provided, directing that they shall invest such Estate in recognised trust securities with power to realise such securities from time to time should they deem it advisable, and to reinvest the proceeds."

The trustee, who was the chairman of the Durban Board of Executors and Trust Company Limited, applied for an order confirming the sale of the Coronation Company shares to certain limited liability companies. An important aspect to highlight is the fact that the trustee was also the chairman and controlling

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[58] 109-110.

[59] 110-111.

[60] 1943 NPD 279.

[61] *Ex parte Executor Testamentary Estate Late Arthur Storm* 1943 NPD 279 280-281.

[62] 281.

shareholder of each of the companies to which he proposed to sell the shares.[63] Mr Storm's widow had consented to the transaction both on her own and on her minor daughter's behalf.[64]

Selke J was not prepared to grant the order for the following reasons: first, he viewed the proposed transaction as one where the trustee presumably stood to derive personal benefit, whether directly or indirectly. Such a situation is one in which a trustee's interest as an individual tends to conflict with his duty as a trustee. In the view of Selke J, the court has always been particularly careful before giving its approval to transactions of this type.[65] Therefore, although the trustee had the consent of the beneficiaries, Selke J was not satisfied that the proposed transaction could be approved.

Second, the Coronation Company was regarded in the market as a "safe lockup investment".[66] This view was also held by the Master who had furnished a report to the application. The Master viewed the Coronation Company as a sound and flourishing company, and an investment in its shares as a "sound investment, far removed from the class of speculative investment".[67] In support of his view, the Master gave the following reasons in his report: the dividends on the shares averaged 28.8% per annum over a period of six years; and the company's balance sheet showed that the company was extremely healthy and in a sound position. Selke J stated that he was in general agreement with the view of the Master.[68]

Third, putting the shares on the open market all at once would almost certainly have resulted in a serious fall in their market price. The trustee would thus have had to realise them for much less than their real value. Selke J felt that it was not necessary or desirable that the trust estate had to make such a sacrifice.[69]

Fourth, Selke J did not understand the provisions of the will to mean that the trustee had to realise the trust's assets immediately, nor did he find any urgency about their realisation. For example, there were no debts or obligations of the trust

[63] 279-280.

[64] 284.

[65] 283-284.

[66] 282.

[67] 282.

[68] 282.

[69] 282.

estate that had to be fulfilled, nor was there any reason to suppose that there would be a serious permanent fall in the value of its shares in the near future. Selke J found that the language of the will suggested that the trustee possessed some degree of discretion as to which assets he would realise and when he would realise them. Applying *Sackville West*, Selke J stated that, in exercising his discretion, the trustee had to have "genuine and exclusive regard to the interests of the estate and of the beneficiaries", and had to act as the "ideal 'prudent and careful man' would act in similar circumstances".[70]

In conclusion, the court *in casu* did not simply order the trustee to sell the shares in the public company in order to invest the proceeds in "recognised trust securities". Instead, it emphasised the importance of considering the circumstances relevant to a particular case, the nature of the investment in question, and what would be in the best interest of the trust's beneficiaries.

2 2 5 Jonsson v Estate Jonsson

In *Jonsson v Estate Jonsson*[71] ("*Estate Jonsson*"), Frederick Leonard Jonsson ("Mr Jonsson") executed a will in 1933 and gave the following directions to his trustees on how trust assets had to be dealt with:[72]

> "… to vary investments from time to time, provided that any investments made by them [the trustees] shall be in first mortgage of rent producing properties in Durban or in British or South African Government or municipal stocks."

Before his death in 1935, he widened his trustees' investment powers by a codicil to his will so that they could invest in "such investments as trustees are entitled to invest moneys in".[73]

Two questions arose in the matter, of which only the second question is relevant for present purposes. The trustees asked the court whether they were entitled to invest the trust funds in any or all of the following investments: the purchase of rent-producing properties anywhere in South Africa; first mortgage upon such properties;

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[70] 282-283.

[71] 1945 NPD 66.

[72] *Jonsson v Estate Jonsson* 1945 NPD 66 67.

[73] 68.

South African or British government or municipal stocks; or stocks of any public utility corporation, such as the Electricity Supply Commission and the Rand Water Board.[74]

Carlisle AJP noted that there was no "fixed list of proper trustee investments" as was the case in English law.[75] Before 1961, trustees in England without wide express powers of investment were limited to the narrow categories of investment set out in the Trustee Act 1925 – principally, fixed-income securities.[76] He referred to *Sackville West* as authority for the view that trustees are obliged to observe due care and diligence in dealing with and investing the money of beneficiaries, and not to expose it to business risks in any way.

After further reference to *Sackville West*, and in particular Kotzé JA's discussion of Voet, Carlisle AJP held that the trustees were entitled to invest the trust funds in any part of South Africa in the purchase of landed property or by way of first mortgage, or in British or South African government or municipal stocks. He emphasised that each particular investment must be selected as a proper one for the trust funds after full and careful investigation has taken place.[77]

Regarding the investment in the stocks of public utility corporations, Carlisle AJP stated that the role of the court is not to say whether such an investment is a proper one or not. The trustees have to decide these matters for themselves:[78]

> "The trustees must exercise their discretion in accordance with the principles which they must follow in regard to such matters as these."

In conclusion, the decision in *Estate Jonsson* is not such a conservative decision as one might think after a first read. Carlisle AJP held that the trustees were entitled to invest in first mortgages on property and in government and municipal stocks, but both mortgages and government and municipal stocks were already permitted in terms of the will. Therefore, the only investment that was permitted that fell outside the terms of the will was the purchase of rent-producing properties. Despite there not

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[74] 68.

[75] 70.

[76] D Grosh "Trustee investment: English law and the American prudent man rule" (1974) 23 *Int'l & Comp LQ* 748 751. For a detailed discussion of the position in England before 1961, see chapter 5 para 2.

[77] *Jonsson v Estate Jonsson* 1945 NPD 66 70.

[78] 70.

being any express direction that the trustees may invest in the stocks of public utility corporations, Carlisle AJP did not confine investment only to properties, mortgages, and government and municipal stocks, but left investment decisions to the trustees.

2 2 6 Ex parte Knight and others

The material facts of *Ex parte Knight and others*[79] ("*Ex parte Knight*") are as follows:[80] the petitioners were the trustees of the testamentary trust of the late Frank Gibaud, the trustees of the testamentary trust of the late Clifford Louis Gibaud ("Clifford Gibaud"), and the trustees of the testamentary trust of Thomas Ponsonby Bagshaw ("Thomas Bagshaw"). The trustees applied to the court for an order authorising them to sell or exchange the shares that they held in their respective capacities as trustees in two private companies, Bagshaw Gibaud & Coy Ltd and Sargent Ltd, for shares in a proposed public holding company, referred to in the case as the "New Company".[81] The application was opposed by one of the beneficiaries of Frank Gibaud's trust.[82]

The directors of both Bagshaw Gibaud & Coy Ltd and Sargent Ltd advised the trustees that it was an opportune time to enter into a reconstruction scheme under which the New Company would purchase the shares of the existing companies. The purchase consideration was in effect an exchange of the shares of the two existing companies for similar shares in the New Company. The trustees asked the court to determine whether they had the necessary power and authority in terms of the respective wills, and also to consider the merits of the proposed reconstruction scheme.[83] Regarding the latter request, the court was essentially asked to advise the trustees whether or not they should embark upon the scheme.

Before arriving at his conclusion, Steyn J discussed the specific duties of trustees in respect of investments. First, the normal powers of trustees include the right to retain the investments in a trust. Second, if the investments received are risky and speculative, it would be negligent for the trustees to maintain them. Trustees should thus realise such investments and invest the proceeds in adequate securities. Third,

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[79] 1946 CPD 800.

[80] The details surrounding the contravention of section 86(bis) of Act 46 of 1926 are omitted.

[81] *Ex parte Knight and others* 1946 CPD 800 802-803.

[82] 808.

[83] 800.

it is the trustees' duty to consider the best interests of all the beneficiaries with due regard to the production of fruits and the security of the corpus. Fourth, how investments are to be made is a matter for the trustees' discretion. Their discretion is, however, always subject to the express directions of the founder or testator limiting their powers and discretion. Fifth, it is not the function of the court to advise trustees as to the exercise of the discretion vested in them, or to confirm their actions done in pursuance thereof. Instead, it is the function of the trustees to weigh up the advantages and disadvantages of certain investments opportunities and to come to a decision thereon.[84]

On examination of the three wills, Steyn J concluded that with regard to Frank Gibaud's trust and Clifford Gibaud's trust, the trustees had the power under the trusts to consent to a reconstruction scheme; with regard to Thomas Bagshaw's trust, the trustees had a similar power since all the interested persons under the trust had consented to the reconstruction scheme.[85]

Steyn J decided to confine his decision only to the interpretation of the powers in the wills. Since the trustees already had the necessary powers of investment, he held that it was for them to determine whether or not they would exercise the discretion that was vested in them.[86] Steyn J did not, therefore, confine the investment of the trust funds only to certain investments, but left the investment decisions to the discretion of the trustees. This was despite the fact that none of the trust documents gave an express direction that the trustees could invest in the shares of a public company.

2 2 7 Ex parte Stein

In *Ex parte Stein, NO*[87] ("*Ex parte Stein*"), Sam Stein ("Mr Stein") died in 1934 and created a trust by appointing his three sons as his sole heirs in equal shares and providing that their inheritances should not be paid out until 25 years after the date of his death.[88] In his will, he provided that the trust funds should be invested either in

[84] 813-814.

[85] 818-819.

[86] 801 and 814.

[87] 1948 4 SA 763 (W).

[88] *Ex parte Stein, NO* 1948 4 SA 763 (W) 764.

immovable property or in first mortgage thereon.[89] After selling certain immovable properties in 1947, the trustee invested a portion of the proceeds in shares in certain building societies and in deposits on current accounts with such societies. These investments, though not specifically authorised by the will, were effected because the trustee did not want trust funds to lie idle until permanent investments in immovable property or first mortgage could be secured.[90]

The trustee applied, first, for an order confirming his action in making these investments; second, for authority to place trust funds on deposit with certain specified building societies from time to time and to purchase shares therein; and third, for authority to acquire shares in one or more private companies where the principal assets consist of immovable property.[91] Murray J was prepared to grant the first and second prayers, but he was not prepared to grant the trustee the power to acquire shares in private property companies.[92] The two main reasons for granting the second prayer was because there was a statute at the time that exercised official control over building societies, and the investments in building societies were only a temporary measure pending final investment of the character specified in the trust.[93]

Murray J expressly refused the authority to invest in the shares of private companies despite the fact that such an arrangement had been consented to by all the beneficiaries.[94] Is this case then an example of the court taking a conservative approach in that it limited the investment of trust funds to fixed-income investments only? The answer to this question is no. The Master gave various reasons for the general inadvisability of permitting the investment of trust funds in the shares of private companies:[95]

> "… due to the normal fluctuations in value thereof, the possibility of prejudice owing to the exercise by directors and shareholders of their rights connected with such companies, the difficulty of controlling the activities of a trustee in his dealings with such shares either as

[89] 767.

[90] 765.

[91] 765-766.

[92] 768.

[93] 766.

[94] 767-768; *Ex parte Van Hasselt* 1965 3 SA 422 (W) 426.

[95] *Ex parte Stein, NO* 1948 4 SA 763 (W) 766-767.

a shareholder or a director, and the possibility that a lower standard of diligence may be required of a trustee in his capacity as a director."

Murray J stated, however, that his principal difficulty lay elsewhere. The trustee was given specific directions as to the method in which trust funds had to be invested – he had to invest in immovable property or in first mortgage thereon. Since, in Murray's J opinion, an investment in shares is not entirely the same as the ownership of land, the trustee could not invest in the shares of private property companies.[96] Therefore, in *Ex parte Stein*, an investment in shares was refused simply because the testator's will circumscribed the trustee's powers of investment.[97]

2 2 8 Peffers, NO v Attorneys, Notaries and Conveyancers Fidelity Guarantee Fund Board of Control

In *Peffers, NO v Attorneys, Notaries and Conveyancers Fidelity Guarantee Fund Board of Control*[98] ("*Peffers v Board of Control*"), an attorney as co-executor stole certain moneys from the estate of Alexander Collie Peffers ("Mr Peffers") who died in 1953. The action was brought against the Board of Control of the Attorneys, Notaries and Conveyancers Fidelity Guarantee Fund (the "Board of Control") for the payment of the money stolen. The plaintiffs were the widow of Mr Peffers and Barclays Bank in their capacities as executors and administrators of the estate of the late Mr Peffers.[99]

Theron J concluded that an investment in an unsecured loan to an individual, even though his financial position may be judged to be sound, would undoubtedly not be considered to be a proper investment for trust funds. Loans of this type should be avoided, unless the trust instrument in question specifically authorises it.[100] The Board of Control was found liable in respect of the loss suffered.[101]

Theron J considered it relevant to the case to obtain clarity on the legal position of administrators or trustees in relation to the investment of trust funds entrusted to

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[96] 767-768.

[97] *Ex parte Van Hasselt* 1965 3 SA 422 (W) 426.

[98] 1965 2 SA 53 (C).

[99] *Peffers, NO v Attorneys, Notaries and Conveyancers Fidelity Guarantee Fund Board of Control* 1965 2 SA 53 (C) 54A-B.

[100] 56A.

[101] 62E.

them for administration. He confirmed that there was no statute in South Africa – as there was in England – stipulating that trustees should invest only in certain types of investment. Instead, trustees are required to invest the funds entrusted to their care with diligence and safety. The standard of care required from trustees is higher than that which the ordinary man generally observes in the management of his own affairs: it is the standard of the *bonus et diligens paterfamilias*. Theron J explained that the high standard of care demanded by our law had resulted in a general acceptance by all persons concerned with the administration of trusts and estates that only certain classes of investment were by nature suitable for the investment of trust funds.[102] According to Theron J, these are:[103]

> "Government or Municipal stocks, loans secured by first mortgage bonds over immovable property, fixed deposits in a reputable bank or trust company or building society, and so forth."

Note that Theron J concludes the list with the words "and so forth", which indicate that the list should not be seen as a closed list (*numerus clausus*). Therefore, the list includes other types of fixed-income investment as well as other investments deemed to be safe, such as the purchase of rent-producing properties.[104]

2 2 9 Ex parte van Hasselt

In *Ex parte van Hasselt*[105] ("*Van Hasselt*"), an application was made for the appointment of a *curator bonis* to Carel Louis van Hasselt ("Mr Van Hasselt") who was alleged to be incapable of managing his affairs. Mr Van Hasselt was 77 years of age at the time and, according to the medical evidence, his life expectancy was three years at the utmost. Lilias Ivuna van Hasselt ("Mrs Van Hasselt") with the concurrence of the *curator ad litem* and Mr and Mrs Van Hasselt's major son (hereafter referred to as the "applicants") requested the court to authorise the *curator bonis* to invest Mr Van Hasselt's funds in shares on the Johannesburg Stock Exchange ("JSE"). The court also had to decide whether to qualify the power to operate on the sharemarket with certain provisions. The applicants suggested that

[102] 55E-H.

[103] 55H-56A.

[104] See para 2 3 2 below.

[105] 1965 3 SA 422 (W).

the *curator bonis* had to consult with and receive the approval of a stockbroker; had to report to the Master, giving full particulars of transactions already completed; and had to be subject to instant dismissal by Mr and Mrs Van Hasselt.[106]

Hiemstra J declared Mr Van Hasselt incapable of managing his affairs and appointed a *curator bonis*.[107] The Master felt that it should not to be charged with the duty of approving share investments. Hiemstra J agreed and found that the Master was not equipped for the discharge of such a duty since it involves "great expertise and minute attention to detail".[108] It was ordered that the *curator bonis* could invest and reinvest the funds under his control in shares on the JSE, provided that he first had to consult with and receive approval from a stockbroker and that Mr and Mrs Van Hasselt could at any time cancel the authority given in this regard.[109]

Hiemstra J stated that the following features of the case were important considerations for him: first, Mr Van Hasselt had previously, while still of lucid mind, entrusted the person who was appointed as *curator bonis* with control over dealings in his portfolio; second, Mrs Van Hasselt and the couple's son, the only eventual beneficiaries of the estate, strongly supported the application; third, the case did not involve protecting the interests of minors; fourth, the *curator ad litem* assured the court that, whatever may happen to the share investments, there would always be sufficient funds to ensure the comfort of Mr Van Hasselt during his lifetime and to meet any urgent cash commitments; fifth, Mr Van Hasselt's life expectancy was only about three years; and sixth, the investments were spread over fifteen companies.[110]

The Master suggested that it would be highly dangerous to authorise share dealings. Hiemstra J did not deny that there are many hazards implicit in investing in shares on the JSE, but clarified this by stating that investing in fixed-income securities also has its disadvantages. He explained that, because of inflation, the value of money is uninterruptedly and steadily declining.[111] According to Hiemstra J, a well-spread portfolio of ordinary shares selected with care and kept under constant

[106] *Ex parte Van Hasselt* 1965 3 SA 422 (W) 423-424.
[107] 427.
[108] 426.
[109] 425-427.
[110] 426.
[111] 424 and 426.

supervision by experts in this field constitutes a form of investment that was suited to the requirements of the most prudent investor.[112]

What makes the decision in *Van Hasselt* significant, is that Hiemstra J provided an insight that seems to have eluded trustees for many years. He showed that there was nothing in the authorities referred to in *Sackville West* that suggested a preference for a particular type of investment:[113]

> "The seventeenth and eighteenth century writers referred to by the Appellate Division in 1925 expressed no preference for a particular type of security. They merely insist on prudence on the part of a trustee."

Therefore, an important principle to be taken from *Van Hasselt* is that there is no justification for a hard-and-fast rule that precludes the investment of trust assets on a recognised stock exchange.[114]

2 2 10 Ex parte Bennett

In *Ex parte Bennett, NO* [115] ("*Ex parte Bennett*"), Mary Sheila Bennett ("Mrs Bennet") in terms of her last will bequeathed a comparatively large sum of money in trust with powers of investment which, in the will, were expressed in the following terms:[116]

> "… to hold the same in the same state as it may be at the time of my death and with power to realise a portion or the whole thereof either by public auction or by private treaty, and to reinvest the proceeds derived therefrom upon trust securities and in shares in public companies, shares in building societies, fixed deposits and savings accounts …"

The trustees sought an order that declared that in terms of the will they were authorised to invest capital funds belonging to the trust in collective investment schemes (unit trusts).[117] Mrs Bennet's husband (the income beneficiary) and her

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[112] 425 and 426-427.

[113] 425.

[114] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 558E.

[115] 1969 3 SA 598 (N).

[116] *Ex parte Bennett, NO* 1969 3 SA 598 (N) 598G.

[117] 599A.

children (the capital beneficiaries) consented to the granting of the relief sought by the trustees.[118]

According to Fannin J, money invested in the units of a unit trust is invested in the shares and other securities that constitute the unit portfolio. The important question was whether an investment in the units of a unit trust would constitute an investment in "shares in public companies" and thus within the meaning of that particular phrase in the will.[119] Fannin J found that an examination of the contents of unit portfolios will often reveal that some securities, which are not shares, are included in unit portfolios.[120] Unit trusts will often include debentures, debenture stock, debenture bonds and unsecured notes; these investment classes are clearly distinguishable from shares in public companies.[121] In coming to his conclusion, Fannin J did not overlook the argument that these investments (debentures etc.) might be seen as so-called "trust investments" and that, on that basis, the trustees should be allowed to invest in unit trusts.[122] Regarding this line of reasoning he remarked that:[123]

> "Even where the debentures, debenture stock or debenture bonds are secured by mortgage bonds over the assets of the company, and may thus constitute 'trustee securities', that cannot be said of unsecured notes, which, by their very title, indicate that they represent unsecured debts due by the company which issued them."

Fannin J concluded that it was impossible to say that the holder of units in a unit trust will always hold an investment in shares in public companies and thus refused the order. Miller J concurred.[124]

The court *in casu* was not asked to decide whether it was proper to invest in unit trusts in terms of the common law, nor was the question before the court whether investments in unit trusts could be regarded as trust investments. The court also did not express any opinion on these two questions.[125] The trustees' argument was confined to whether an investment in unit trusts fell within the power conferred by the

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[118] 598G-H.

[119] 601C-E.

[120] 601H-602A.

[121] 601G-H.

[122] For a discussion of the term "trust investments", see para 2 3 2 below.

[123] *Ex parte Bennett, NO* 1969 3 SA 598 (N) 602A.

[124] 601B and 602D-F.

[125] 602E; Cameron et al *Honoré's Law of Trusts* 378.

will.[126] The decision in *Ex parte Bennett* should, therefore, not be read as authority for the view that in 1969 investing trust funds in unit trusts fell within the ambit of risky investments and that trustees were thus not licensed to invest in such investments.

2 2 11 Ex parte Baumann

In *Ex parte Baumann NO*[127] ("*Ex parte Baumann*"), the testator, Albert Frederick Baumann ("Mr Baumann"), died in 1967 and bequeathed his estate to a trust established by his will. His estate consisted largely of shares in Bakers South Africa Ltd ("Bakers"). His trustees retained the shares in Bakers for fourteen years, after which they sold the shares for more than R3 million in 1981.[128] The will authorised the trustees to realise investments from time to time and reinvest the proceeds in "good sound security".[129] Mr Baumann further stated in a postscript that:[130]

> "As a guide I record that at all times investments either in shares, preference shares or deposits with Bakers South Africa Ltd or their subsidiary companies or associate companies shall be acceptable. In other respects I approve of investments in shares in reputable building societies, or fixed deposits or savings accounts in such societies, or upon first mortgage bonds …"

The trustees wished to invest the proceeds from the sale of the Bakers shares in shares quoted on the JSE. Uncertain about their investment powers, they approached the court for direction.[131] The trustees sought an order declaring that they have a power to invest in shares on the JSE; or if they did not have such a power, they requested the court to give them such a power. All parties interested in the trust fund knew of and supported the application.[132] The trustees believed that investments with building societies or investments in mortgage bonds were not wise

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[126] *Ex parte Bennett, NO* 1969 3 SA 598 (N) 600A.

[127] 1982 2 SA 239 (D).

[128] *Ex parte Baumann NO* 1982 2 SA 239 (D) 240H.

[129] 241D-E.

[130] 241F-G.

[131] 240H.

[132] 241A.

given the state of the country's economy at the time.[133] The trustees were most probably referring to the high average rate of inflation in South Africa from 1981 to 1982.[134] In the trustees' opinion, it was thus more beneficial to the trust fund to invest in shares on the JSE.[135]

In order to answer the question whether the trustees had the power to invest on the JSE, the court had to consider two issues: first, whether Mr Baumann gave precise instructions circumscribing the method of investment of the trust assets; and second, what the correct interpretation of the word "security" was in the will.[136]

Didcott J found that the postscript did not amount to "instructions", nor did it have the effect of limiting the trustees' choice of investments. The postscript merely mentioned the investments that Mr Baumann favoured and was only meant to provide the trustees with some guidance.[137] Regarding the meaning of security, it was found that Mr Baumann intended the word "security" in his will to bear the "extended meaning of investment".[138] Didcott J declared that, according to the correct interpretation of the will, the trustees had the power to invest in shares on the JSE. Furthermore, in order to meet the will's requirements, any investment that the trustees made had to be "good" and "sound" in their opinion.[139]

According to Cameron and others, the *Ex parte Baumann* decision suggests that investing in public companies listed on a stock exchange would be regarded as too risky in the absence of express power in the trust instrument.[140] However, the trustees *in casu* were not given express powers to invest in shares on the JSE: the will simply stated that they had to invest in "good sound security". An example of an

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[133] 241H.

[134] The average rate of inflation in 1981 was 15.28%, and in 1982 it was 14.67%: <https://www.inflation.eu/inflation-rates/south-africa/historic-inflation/cpi-inflation-south-africa-1981.aspx> (accessed 01-02-2019) and <https://www.inflation.eu/inflation-rates/south-africa/historic-inflation/cpi-inflation-south-africa-1982.aspx> (accessed 01-02-2019).

[135] *Ex parte Baumann NO* 1982 2 SA 239 (D) 241H.

[136] 242B and 242D.

[137] 242B-C.

[138] 243A.

[139] 243E.

[140] Cameron et al *Honoré's Law of Trusts* 351.

express power can be found in *Ex parte Bennett* where "shares in public companies" are explicitly mentioned:[141]

> "… to reinvest the proceeds derived therefrom upon trust securities and in shares in public companies, shares in building societies, fixed deposits and savings accounts …"

Furthermore, Didcott J stated that even if the trustees did not have the power to invest on the JSE, he would have given them the opportunity to try and convince him to allow them to invest there. That said, Didcott J made it clear that he would have made such an order only if the trustees provided very good reasons in support of their request.[142] It is, therefore, submitted that the decision in *Ex parte Baumann* is not authority for statements that suggest that investing in companies listed on the JSE would be too risky for trustees to make.[143]

2 3 Summary and analysis of the court cases

Following the discussion of the court cases from 1925 to 1982, it is submitted that the position with respect to trustee investing is as follows:

A person in a fiduciary position, such as a trustee, is at common law under a duty to invest trust funds.[144] This duty does not apply to trust assets unsuited or not intended for investment.[145]

The standard of conduct that is expected from a trustee when undertaking the investment of trust funds is that of the "prudent and careful person". The reasoning behind this statement can be explained as follows: trustees hold an office, which

[141] *Ex parte Bennett, NO* 1969 3 SA 598 (N) 598G.

[142] *Ex parte Baumann NO* 1982 2 SA 239 (D) 243D-E.

[143] For contrasting views, see J De Mink "The stormy waters of trustee investment" (2004) January *DR* 18 19: "For example, as recently as 1982, our courts have held that investing in companies listed on the stock exchange would be too risky"; and LE Balden & C Rautenbach "Die sorgsaamheidsplig van trustees in die uitvoer van hulle beleggingsbevoegdhede: kan ons by die Engelse trustreg leer?" (2005) 30 *TRW* 91 96: "Byvoorbeeld, in *Ex Parte Baumann NO* het die hof beslis dat 'n belegging in 'n maatskappy wat op die effektebeurs gelys is, te riskant van aard is".

[144] *Sackville West v Nourse* 1925 (AD) 516 534; Cameron et al *Honoré's Law of Trusts* 349.

[145] Cameron et al *Honoré's Law of Trusts* 349; MJ de Waal "Die strekwydte van trustees se beleggingsbevoegdheid" (1999) 2 *TSAR* 370 371.

gives rise to their general fiduciary duty.[146] One of the components of trustees' general fiduciary duty, and perhaps the most significant one, is trustees' general duty of care.[147] The extent of care required of trustees is that of the prudent and careful person, or to use the technical expression of Roman law, the standard of the *bonus et diligens paterfamilias*.[148] Today, this standard is echoed in section 9(1) of the Trust Property Control Act 57 of 1988 ("Trust Property Control Act").[149] In South Africa, unlike the position in England, trustees' general duty of care is applicable to both their general administration of trust property[150] and their investment-related functions:[151]

> "A trustee's general duty of care obliges him at common law to undertake the investment of trust funds as a *bonus et diligens paterfamilias* …"

Therefore, the rule that governs how trustees should exercise their investment functions is referred to as the "prudent and careful person rule".

The prudent and careful person rule is applicable to every trust and thus finds application in the following circumstances: where the trust instrument imposes restrictions on the trustees' choice of investments;[152] contains no provisions

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146 *Doyle v Board of Executors* 1999 (2) SA 805 (C) 813; *Breetzke and others NNO v Alexander NO and others* (232/2019) 2020 ZASCA 97 (2 September 2020) para 10. See also F du Toit, B Smith & A van der Linde *Fundamentals of South African Trust Law* (2018) 99 and 113; Cameron et al *Honoré's Law of Trusts* 69; MJ de Waal "The core elements of the trust: aspects of the English, Scottish and South African Trusts compared" (2000) 117 *SALJ* 548 557.

147 Du Toit et al *South African Trust Law* 100. Further components of trustees' general fiduciary duty are the duty of impartiality, the duty of accountability and the duty of independence: 100-101.

148 *Sackville West v Nourse* 1925 (AD) 516 534.

149 Du Toit et al *South African Trust Law* 113; De Waal (2000) *SALJ* 559; S 9(1) of the Trust Property Control Act states: "A trustee shall in the performance of his duties and the exercise of his powers act with the care, diligence and skill which can reasonably be expected of a person who manages the affairs of another".

150 D Hayton "The extent of pension trustees' obligations in South Africa" (2004) *Pension Lawyers* <http://www.pensionlawyers.co.za/wp-content/uploads/2018/10/PensionTrusteesObligations SouthAfrica.pdf> (accessed 06-02-2019) 4.

151 Du Toit et al *South African Trust Law* 138. See also *Sackville West v Nourse* 1925 (AD) 516 535 and *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 557E-F.

152 For example, see *Ex parte Stein, NO* 1948 4 SA 763 (W) 765: "The testator's capital … should be invested … either in the purchase of immovable property or upon first mortgage of immovable property."; and *Ex parte Administrators Estate Finberg* 1947 2 SA 13 (T) 15: "… to invest all proceeds

regarding investments; [153] does not contain detailed provisions regarding investments;[154] and authorises the trustees to invest in riskier types of security.[155]

Therefore, even where trustees are afforded wide powers of investment, they should still consider the prudent and careful person rule carefully, and whether or not to exercise their wider powers. It would be no defence to argue that their actions were justified simply on the ground that they were empowered to act.[156] Trustees who fail to show the required standard of care when investing, and subsequently make an improper investment, commit a breach of trust.[157]

2 3 1 The elements of the prudent and careful person rule

A careful reading of the court cases outlined above reveals that the elements of the prudent and careful person rule can be formulated as follows:

First, it is the duty of trustees to consider the best interest of all the beneficiaries with due regard to the production of fruits and the security of the capital.[158]

Second, the question whether an investment is proper or not is left to the discretion of the trustees. It is evident that the courts are not prepared to advise trustees as to the exercise of the discretion vested in them or to confirm any acts done by them in pursuance of such discretion.[159]

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and surplus income only on first mortgage bonds over rent producing properties in the Municipalities of Johannesburg, Cape Town and Durban, and nowhere else … Under no circumstances shall money be invested in farm mortgage bonds".

[153] For example, see *West v Nourse* 1924 45 NPD 418 419: "There is no term of the trust deed providing for the investment of the money thus acquired."

[154] For example, see *Jonsson v Estate Jonsson* 1945 NPD 66 68: "… such investments as trustees are entitled to invest moneys in."; and *I A Essack Family Trust v Soni* 1973 3 SA 625 (D) 627D-E: "The trustees shall be entitled, and are hereby empowered, at their discretion to invest the trust fund or any portion thereof in the Union of South Africa or elsewhere in whatever manner they may deem fit …"

[155] For example, see *Ex parte Bennett, NO* 1969 3 SA 598 (N) 598: "… and to reinvest … proceeds … in shares in public companies, shares in building societies, fixed deposits and savings accounts …"

[156] WD Geach *Trust Law in South Africa* (2017) 224.

[157] Du Toit et al *South African Trust Law* 113.

[158] *Ex parte Knight and others* 1946 CPD 800 814; Cameron et al *Honoré's Law of Trusts* 351.

[159] *Ex parte Knight and others* 1946 CPD 800 814; see also *Jonsson v Estate Jonsson* 1945 NPD 66 and *Ex parte Baumann NO* 1982 2 SA 239 (D).

Third, in terms of the prudent and careful person rule, whether an investment is prudent or not depends on the circumstances of each particular case.[160] For example, it was judged to be negligent and improper in *Sackville West* to invest upon the security of a hotel property, but under different circumstances the court might have allowed such an investment.[161]

Fourth, trustees must avoid business risks. The need to avoid risks was emphasised in *Sackville West* in the judgments of both Solomon ACJ and Kotzé JA. Both contain *dicta* to the effect that trustees are obliged to avoid investments that are "attended with risk",[162] "attended with hazard", "exposed to risk and hazard", "not a safe and sound investment", are of a "hazardous or uncertain nature", involve "mercantile speculation", and involve "business risks".[163] Kotzé JA concluded that it is the duty of trustees to observe due care and diligence, and not to expose trust funds in any way to any business risks.[164]

According to Williams, this statement – that it is the duty of trustees not to expose trust funds to business risks – has been interpreted to mean that any investment in which the capital of the investment might decline in value was not proper for trustees to make.[165] Williams does not provide authority for this strict interpretation of Kotzé JA's statement. At first glance, it might seem that *Die Kerkraad, Nederduitse Gereformeerde Kerk v Colonial Orphan Chamber and Trust*[166] ("*Colonial Orphan Chamber*") provides authority for such an interpretation. However, *Colonial Orphan Chamber* is a somewhat singular case since it was a special condition *in casu* that the trustees had to guarantee the trust capital.[167] In *Sackville West*, Solomon ACJ accepted that the value of some investments may fluctuate:[168]

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[160] *Sackville West v Nourse* 1925 (AD) 516 521 and 536; *Colonial Banking and Trust v Estate Hughes* 1932 AD 1 15-16.

[161] *Sackville West v Nourse* 1925 (AD) 516 521.

[162] 520.

[163] 535-536.

[164] 535; *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 557E.

[165] RC Williams "The investment of trust moneys" (2001) 13 *SA Merc LJ* 311 311.

[166] 1944 CPD 464.

[167] *Die Kerkraad, Nederduitse Gereformeerde Kerk v Colonial Orphan Chamber and Trust* 1944 CPD 464 471.

[168] *Sackville West v Nourse* 1925 (AD) 516 521.

"Now it seems to me to be of the greatest importance to bear in mind that the value of the land and the hotel buildings would necessarily fluctuate with the success or otherwise of the hotel business."

Solomon ACJ did not, however, as a general rule prohibit the investment in such investments. Instead, he stated that trustees should take factors such as fluctuations into consideration and adjust the manner in which they invest when investing in certain types of investment:[169]

"Considerations of this nature should be present to the mind of a reasonable man, who should not, therefore, invest money on such security as this without a very ample margin."

Fifth, if trustees receive investments that are speculative, they should sell them and reinvest the proceeds in safer investments.[170] The term "speculative investment" is an amorphous term and none of the court cases discussed provides a definition of the term. One should not automatically assume that the term refers to "shares". In *Ex parte Storm*, the trustees were allowed to invest in the shares of a certain public company since the court regarded the investment as a sound investment, far removed from the "class of speculative investment".[171]

Sixth, the prudent and careful person rule expresses no preference for a particular type of investment. This statement requires explaining. Hiemstra J stated in *Van Hasselt* that the seventeenth and eighteenth century writers referred to in *Sackville West* expressed no preference for a particular type of security.[172] This was also the position in *Learoyd*, one of the cases referred to in *Sackville West*, and the position in the *Sackville West* judgment itself. The Appellate Division did not find it negligent and improper in all circumstances whatsoever for trustees to invest trust funds upon the security of a hotel property. Therefore, under different circumstances, it might have been possible that no objection could have been taken to the nature of such an investment.[173]

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[169] 522.

[170] *Ex parte Knight and others* 1946 CPD 800 814; Cameron et al *Honoré's Law of Trusts* 349; Frere-Smith *South African Trust Law* 79.

[171] *Ex parte Executor Testamentary Estate Late Arthur Storm* 1943 NPD 279 282.

[172] *Ex parte Van Hasselt* 1965 3 SA 422 (W) 425.

[173] See para 2 2 1 1 above.

Finally, the prudent and careful person rule was not interpreted in subsequent judicial decisions as limiting the investment of trust funds only to particular investments; the courts merely insisted on prudence on the part of trustees.[174] For example, in *Ex parte Harrington*, the court allowed the trustees to invest in gold shares; in *Ex parte Storm*, the court regarded the shares in a certain public company as a sound investment; in *Estate Jonsson*, the court did not prohibit the investment in stocks of certain public utility corporations; in *Ex parte Knight*, the court did not proscribe the investment in shares of a certain public company; and in *Ex parte Stein*, the court allowed the trustee to invest in, among other things, the purchase of shares in building societies.[175]

Although the authorities referred to in *Sackville West* expressed no preference for a particular type of investment, it is evident from these authorities that, unless the trust instrument directs otherwise, trustees do not have the power to carry on a business with the assets of a trust estate.[176] Therefore, at common law, trustees have no power without an express power in the trust instrument to, for example, expose trust assets to farming risks[177] or conduct a hardware business through a trust.[178]

Taking the above elements into consideration, it appears that in some respect the prudent and careful person rule resembles one of the versions of the prudent man rule in the United States. To be more specific, the South African rule resembles the "traditional prudent man rule" in that the latter rule did not express any preference for a particular type of investment, but instead relied on the skill and care of trustees to decide whether an investment is prudent or not.[179]

2 3 2 The emergence of a generally accepted practice of investing

The high standard of care demanded by the *dicta* of *Sackville West* resulted in a generally accepted practice that only certain classes of investment were by nature

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[174] *Ex parte Van Hasselt* 1965 3 SA 422 (W) 425.

[175] See paras 2 2 3 to 2 2 7 above.

[176] *Sackville West v Nourse* 1925 AD 516 535; Cameron et al *Honoré's Law of Trusts* 360.

[177] *Ex parte Bellingan's Executors* 1936 CPD 515 517.

[178] *I A Essack Family Trust v Soni* 1973 3 SA 625 626F and 627G-H.

[179] For discussion of the traditional prudent man rule, see chapter 4 para 2 2.

suitable for the investment of trust funds.[180] It is important to stress that it was the practice of trustees and not the courts to confine the investment of trust funds to trust investments.[181] This development is hereafter referred to as the "conservative approach". It is generally accepted that the term trust investments includes the following: government or municipal stocks, fixed deposits, loans secured by first mortgage bonds over immovable property, and the purchase of rent-producing properties.[182] Trustees followed the conservative approach especially in cases where they were not given wider powers of investment.[183] However, there is a strong possibility that the conservative approach was also followed in cases where trustees had wider powers of investment.[184] It is important to point out that investing in trust investments does not dispense with the need for trustees to observe due care and diligence. The suitability of each particular investment contemplated still has to be investigated carefully.[185]

Hiemstra J in *Van Hasselt* signalled a movement away from the conservative approach.[186] As discussed above, Hiemstra J rejected the notion that a *curator bonis* had to invest the funds of the person whose estate he was administering only in trust investments. Hiemstra J took the view that there was nothing in the authorities cited in *Sackville West* that suggested a preference for a particular type of investment.[187] However, the practice of preferring conservative investments was widespread and it was thus unlikely that the statements of Hiemstra J would uproot it.[188]

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[180] *Peffers, NO v Attorneys, Notaries and Conveyancers Fidelity Guarantee Fund Board of Control* 1965 2 SA 53 (C) 55H; *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 557G; Williams (2001) *SA Merc LJ* 311.

[181] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 557G.

[182] *Peffers, NO v Attorneys, Notaries and Conveyancers Fidelity Guarantee Fund Board of Control* 1965 2 SA 53 (C) 55H; Williams (2001) *SA Merc LJ* 311.

[183] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 557G.

[184] See Williams (2001) *SA Merc LJ* 311; Kunene (2001) *INS TAX* 3.

[185] *Jonsson v Estate Jonsson* 1945 NPD 66 70; Cameron et al *Honoré's Law of Trusts* 353.

[186] De Waal (1999) *TSAR* 374.

[187] See para 2 2 9 above.

[188] Kunene (2001) *INS TAX* 3.

3 The South African Law Commission's report

The Law Commission published a Working Paper[189] in February 1984 and its report[190] on the law of trusts in June 1987.[191] In the report, the Law Commission discussed a number of issues relating to trust law reform. For present purposes, only the sections that deal with the investment of trust funds are relevant.

3 1 The position according to the Law Commission

The Law Commission, after briefly discussing some of the views concerning the investment of trust assets from Corbett and others[192] and Honoré,[193] concluded that no prudent man rule applied in South Africa.[194] It is unclear which version of the prudent man rule the Law Commission refers to. From 1940 to 1992, what was ordinarily understood in the United States as the prudent man rule (sometimes also referred to as the prudent *person* rule), was in fact the traditional prudent man rule as influenced by the work of Scott. In chapter 4, this version of the prudent man rule is referred to as "Scott's prudent man rule".[195] Nevertheless, the point is that the Law Commission concluded that no version of the prudent man rule applied. Instead, what applied in our law, according to the Law Commission, was a court list approach.

The Law Commission described the court list approach as follows: trustees must comply with the express directions in the trust instrument. In the absence of express directions, trustees should confine their investments to trust investments.[196] As discussed above, trust investments include government or municipal stocks, loans secured by first mortgage bonds over immovable property, fixed deposits, and investments in immovable property.[197] Investments in public companies (companies listed on a stock exchange) – whether industrial, commercial or mining companies –

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[189] South African Law Commission *Project 9 The Law of Trusts* (1983) Working Paper 3.

[190] South African Law Commission *Project 9 The Law of Trusts* (1987) Report.

[191] South African Law Commission *The Law of Trusts* Report 1.

[192] MM Corbett, HR Hahlo, G Hofmeyr & E Kahn *The Law of Succession in South Africa* (1980).

[193] T Honoré *The South African Law of Trusts* 3 ed (1985).

[194] South African Law Commission *The Law of Trusts* Report 57-58.

[195] See chapter 4 para 3.

[196] South African Law Commission *The Law of Trusts* Report 58.

[197] See para 2 3 2 above.

are regarded as too risky in the absence of an express power contained in the trust instrument.[198]

The Law Commission noted that the case for allowing investment in public companies had been put forcibly by Hiemstra J in *Van Hasselt*, but it dismissed the importance of the case because it was a *curator bonis* case in which the patient himself had previously invested on the stock exchange.[199]

3 2 The problem with a court list approach

At the time when trust investments became relevant, inflation was either non-existent or of little consequence.[200] However, inflation has been substantial since 1945. No economist foresaw or could have possibly foreseen anything like the inflation that has occurred since then. The effective increase in consumer prices between 1945 and 1982 amounted to 825.5%.[201] Relating that to a figure of R150 000 in 1945, the equivalent in 1982 would have been R1 238 250. A capital amount invested in 1945 and safely returned in 1982 could thus only buy one-eighth of what it could buy in 1945.

As discussed in the preceding section, the Law Commission found that a court list approach existed in our law. As a result, trustees had to restrict their investments only to trust investments. Except for investments in immovable property, all trust investments are fixed-income investments.[202] In economic conditions of low inflation, such investments produce a reasonable income and secure the rand value of the capital invested.[203] However, during periods of high inflation, fixed-income investments do not protect the erosion of the real value of the trust capital.[204] For example, assuming that the returns on fixed-income investments are in the order of 7%, the returns payable to a trust's income beneficiaries would probably be closer to 4% per annum after tax.[205] If money is depreciating at, say 6% per annum, the

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[198] South African Law Commission *The Law of Trusts* Report 58; Honoré *Law of Trusts* 233-234.

[199] South African Law Commission *The Law of Trusts* Report 58.

[200] 49.

[201] *Ex parte Sidelsky* 1983 3 SA 509 (C) 511.

[202] South African Law Commission *The Law of Trusts* Report 59.

[203] Ontario Law Reform Commission *Report on the Law of Trusts* (1984) Volume 1 217.

[204] South African Law Commission *The Law of Trusts* Report 59.

[205] *Ex parte Ewing NO: In Re Sheridan* 1995 2 SA 288 (D) 289.

capital invested is necessarily undergoing a process of devaluation.[206] As a result, not only do the trust's capital beneficiaries suffer a considerable loss, but the income beneficiaries are also affected negatively. Should the capital invested be permitted to erode in value in real terms, it is inevitable that the real income available for the income beneficiaries will increasingly reduce and eventually cease to be of any significance.[207]

To summarise, the problem that the Law Commission identified was that a court list approach could not counter inflation. Therefore, the court list approach was not an appropriate approach to trustee investing.

3 3 Possible solutions to the problem

The Law Commission considered three possible solutions to the problem: replace the court list approach with a "legal list" approach; replace the court list approach with some version of the prudent man rule;[208] or enact legislation whereby the court may vary trust provisions in certain circumstances.[209]

3 3 1 A legal list approach

Some commentators on the Working Paper proposed a legal list approach to trustee investing.[210] In brief, a legal list approach offers a range of investments that have received the sanction of the legislature and provides statutory guidelines regarding the permitted percentage of the trust fund that may be invested in particular investments.[211] The arguments in favour of a legal list approach are: first, non-professional trustees may take comfort in the knowledge that, in all probability, they will not incur liability for breach of trust on the grounds of improper investment if they keep to the legal list. Second, a legal list may sometimes provide protection

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[206] *Ex parte Wagner NO: In Re De Bie* 1988 3 SA 190 (C) 191.

[207] Ontario Law Reform Commission *Report on the Law of* Trusts 217-218; *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 556G.

[208] South African Law Commission *The Law of Trusts* Report 49.

[209] 59.

[210] 59.

[211] 50-51; Ontario Law Reform Commission *Report on the Law of Trusts* 216.

against beneficiaries who insist on investments that are riskier than what the trustees would consider to be wise in the circumstances.[212]

The arguments against a legal list are: first, it is not possible to draw up a simple list that would suit the circumstances of every trust. According to the Law Commission, the size of the trust fund, the benefits intended by the founder for the beneficiaries, the needs of the beneficiaries, and the expected duration of the trust are all factors that play a part in determining suitable investments for the particular trust. Second, a legal list approach cannot keep pace with changing economic circumstances. Even if the list of authorised investments is updated regularly, a legal list approach is not flexible enough to provide for all the different cases and changing circumstances.[213] Third, a legal list approach may encourage trustees to "play it safe" by keeping to the legal list, rather than properly investigating which investments are really the most suitable for the particular trust.[214]

The Law Commission thus felt that the advantages of a legal list approach were outweighed by its disadvantages.[215]

3 3 2 The prudent man rule

Another proposal that was considered, was introducing the prudent man rule in one form or another.[216] All versions of the prudent man rule require trustees to act with the care and discretion of a prudent man when investing trust funds.[217] The rationale for adopting the prudent man rule is that it allows trustees flexibility to respond to changing economic and financial conditions that would assist in protecting the trust estate.[218] The Law Commission discussed four points of criticism of the prudent man rule as they understood it: first, the Law Commission was concerned that the rule may not provide sufficient guidance to inexperienced trustees. However, the Law Commission noted that nothing prevented non-

[212] South African Law Commission *The Law of Trusts* Report 53; Ontario Law Reform Commission *Report on the Law of Trusts* 217.

[213] South African Law Commission *The Law of Trusts* Report 53-54.

[214] 55; Ontario Law Reform Commission *Report on the Law of Trusts* 217.

[215] South African Law Commission *The Law of Trusts* Report 59.

[216] 60.

[217] Ontario Law Reform Commission *Report on the Law of Trusts* 217.

[218] 218; South African Law Commission *The Law of Trusts* Report 55.

professional trustees from obtaining investment advice.[219] The first criticism thus merely emphasised that expert advice is necessary when investing trust funds.[220]

Second, according to the Ontario Law Reform Commission, it had been suggested that the prudent man rule requires trustees to guess in advance the kind of investments that the court may later determine to be suitable for the investment of trust assets if an action for breach of duty is commenced.[221] However, upon further investigation, the South African Law Commission could not find any proof of such a state of affairs.[222]

Third, according to the Law Commission, it was sometimes argued that the prudent man rule benefits capital beneficiaries at the expense of income beneficiaries.[223] In response to this argument, the Ontario Law Reform Commission explained that, in truth, both income and capital beneficiaries benefit under the prudent man rule:[224]

> "… the intention of the prudent man concept is not only to permit investment in equities at times of high inflation in order to protect capital, but also to permit diversification of investment to meet the various needs of a trust during all kinds of changing economic and financial conditions."

Fourth, the Law Commission claimed that the prudent man rule implies that trustees may sometimes "ignore the directions in the trust document".[225] The Law Commission did not provide any further explanation, nor did it provide any authority for this claim. It is therefore uncertain where this notion stems from. Since no authority has been provided to substantiate such a claim, it is submitted that the power to ignore directions in the trust document is not one of the elements of any of the versions of the prudent man rule.

In summary, none of the four points of criticism of the prudent man rule is convincing. Despite not having any real arguments against the prudent man rule, the

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[219] South African Law Commission *The Law of Trusts* Report 56.

[220] Ontario Law Reform Commission *Report on the Law of Trusts* 218.

[221] 218.

[222] South African Law Commission *The Law of Trusts* Report 56-57.

[223] 55.

[224] Ontario Law Reform Commission *Report on the Law of Trusts* 218.

[225] South African Law Commission *The Law of Trusts* Report 60.

Law Commission decided not to recommend the rule as the solution to the problem discussed above.

3 3 3 The amendment of a trust's provisions in certain circumstances

The final solution that the Law Commission considered, was to enact legislation that would allow the court to vary the provisions of a trust instrument that resulted in "the unprofitable investment of trust property". The Law Commission's draft bill embodied a recommendation to this effect.[226]

This recommendation was, however, not enacted.[227] That said, where excessive rigidity constrains desirable or necessary investment powers, section 13 of the Trust Property Control Act creates an avenue for possible change in the investment powers of trustees.[228]

3 4 Summary

The Law Commission found that no prudent man rule applied in South Africa; instead, a court list approach operated in our law. This claim thus contradicts the conclusion reached in section 2 3 above. The discussion of *Estates Richards* in the following section provides clarification to the question of precisely which approach applies in our law.

The Law Commission accepted that, because of the increase in the rate of inflation in the second half of the twentieth century, a situation where trustees could only invest in fixed-income investments created a problem for beneficiaries. Three solutions for reform were considered. The Law Commission decided not to recommend a legal list approach or a version of the prudent man rule, and its recommendation regarding the amendment of trust instruments was not adopted.

4 The approach to trustee investing after 1998

This section begins by discussing the facts of *Estate Richards* and the conclusion reached in the case. Following this discussion, the section explains the conclusion reached regarding trustees' investment standards in more detail and highlights what

[226] 59; Cameron et al *Honoré's Law of Trusts* 355.

[227] Cameron et al *Honoré's Law of Trusts* 355.

[228] 303; De Waal (1999) *TSAR* 378.

is regarded as the most important contribution to trustee investing that the case makes. Thereafter, the section presents a criticism of the conclusion reached in the case and considers whether the criticism is justified. Finally, the section briefly discusses two cases on the subject of trustee investing decided after *Estate Richards*.

4 1 Facts and conclusion reached in *Estate Richards*

In *Estate Richards*, John Herbert Richards ("Mr Richards") executed a will in 1953 and died two years later.[229] He was survived by his widow, his widow's daughter, and the latter's daughter, who was thus his step-grandchild.[230] In his will, he bequeathed certain movable property as well as a right of occupation to his widow. The residue of his estate was bequeathed in trust.[231] The trustees were a partner of a well-established firm of attorneys and the Board of Executors, a trust company of Cape Town.[232] From the trust income, the trustees had to pay annuities to certain family members, including Mr Richards' widow and stepdaughter.[233] The will made no provision for the distribution of the capital of the trust since Mr Richards expressed the desire that the trust shall "continue in perpetuity".[234] At the time of the judgment, Mr Richards' step-grandchild was the sole surviving beneficiary.[235]

It was apparent from the provisions of the will that Mr Richards had considerable confidence in the trustees. For instance, clause 4 of the will afforded the trustees wide powers of investment:[236]

> "… at their own absolute discretion (to) retain, release or reinvest any proceeds of any realisation of the whole or part in such manner and upon such security as to my administrators may seem fit".

Similarly, clause 11 conferred wide powers on the trustees:[237]

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[229] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 554B.
[230] *Administrators, Estate Richards v Nichol* 1996 4 SA 253 (C) 255G-I.
[231] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 554B-C.
[232] *Administrators, Estate Richards v Nichol* 1996 4 SA 253 (C) 256E.
[233] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 554C.
[234] 556B.
[235] 554I.
[236] 556I-J.
[237] 557A-B.

"My executors shall have the power to sell, deal with and dispose of any asset in my estate and my said administrators shall in addition to the powers of investment conferred upon them in clause 4 of this my will, have full power at their absolute discretion to realise or acquire property, both movable and immovable, also power to settle, adjust or compromise any claim due to or by me or my estate, and power to deal with any investments and to apportion or discriminate between capital and interest in their discretion."

The questions in issue in the appeal related solely to the powers of investment afforded to the trustees.[238] The trustees sought an order authorising them to:[239]

"… in their discretion, invest and from time to time to reinvest, any assets in the estate in such suitable trustee investments and/or securities quoted on any licensed stock exchange and/or in licensed unit trusts as applicants may deem appropriate."

The court *a quo* granted and order to this effect, but substituted the words "any licensed stock exchange" with "Johannesburg Stock Exchange". It also attached three more restrictions to the investment of trust assets: first, investments in shares and unit trusts were limited to 50% of the value of the trust assets; second, the trustees had to obtain advice and approval from an independent stockbroker before making any investment; and third, the trustees had to render a quarterly report to the Master setting out the details of such investments. The trustees appealed against the decision of the court *a quo*.[240]

Scott JA held that he could see no justification for a hard-and-fast rule precluding the investment of trust funds in shares or unit trusts.[241] He cautioned, however, that every investment in shares and unit trusts involves an inherent risk of capital loss, and that a trustee who exercises due care and diligence will bear this in mind. He also held that, in managing a trust portfolio, trustees should avoid investments that are of a speculative nature. Furthermore, the extent to which it is prudent to invest in the share market will depend on the circumstances of each case, but generally speaking, trustees should as far as practicable seek to spread investments over

[238] 555B.

[239] 555D-E.

[240] 555D-G.

[241] 558C.

various forms of undertaking in order to obtain a balance of stability and growth in the capital value of the trust and the income it produces.[242]

Regarding the four restrictions imposed by the court *a quo*, Scott JA held that all of them were inappropriate.[243] First, "in the light of modern developments" there was no reason for restricting investments to shares quoted on the JSE.[244] Second, the 50% limit on investments in shares or unit trusts was not justified. The need for flexibility in the administration of a trust, particularly one intended to be of long duration, is essential. What is prudent in particular circumstances may vary from well below 50% to well above it.[245] Third, the requirement that the trustees had to obtain advice and approval from an independent stockbroker before investing in shares or unit trusts was neither necessary nor appropriate. The trustees enjoyed the benefit of advice from a team of investment experts of one of the trustees, the Board of Executors.[246] Fourth, there was no good reason for the requirement that trustees had to render a quarterly investment report to the Master. The Master was on record in an earlier decision as saying that he did not want to be burdened with such a responsibility.[247]

Ultimately, Scott JA held that the appeal had to succeed.[248]

4 2 Discussion of the conclusion reached in *Estate Richards*

Scott JA acknowledged the existence of the conservative approach and took the opportunity to consider the practice amongst fiduciaries of preferring so-called trust investments.[249] He pointed out that already in 1965, the *Van Hasselt* judgment signalled a movement away from the conservative approach.[250] However, the decision did not adequately solve the problem faced by trustees. The practice of

[242] 558H-I.

[243] Williams (2001) *SA Merc LJ* 312.

[244] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 560D.

[245] 560E-G.

[246] 560F; De Waal (1999) *TSAR* 375.

[247] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 560I-561A.

[248] 561E-G.

[249] 557G and 558C.

[250] 558B-G; De Waal (1999) *TSAR* 374; Kunene (2001) *INS TAX* 2.

preferring trust investments was widespread and it was thus unlikely that the statements of Hiemstra J would uproot it.[251]

Scott JA approved the dictum of *Van Hasselt* that stated that fiduciaries should not have a preference for a particular type of security.[252] Therefore, the only requirement in our law is that the investments of trust assets should be prudent. Such prudence is a matter that is determined by the trustees and not the court.[253] Scott JA confirmed that trustees have to, and have always had to, follow the prudent and careful person rule formulated in the *Sackville West* decision.[254] As discussed above, the Law Commission concluded that the rule that applied in our law was a court list approach.[255] It is submitted that the conclusion reached by the Law Commission is thus incorrect.

In *Estate Richards*, it was also confirmed that whether or not an investment can be said to have been prudent or made with due care and diligence is a question that can only be determined in the circumstances of each particular case.[256] "Circumstances" can be divided into circumstances relevant to the particular trust (hereafter referred to as "specific circumstances") and "general circumstances".

Examples of specific circumstances are: the ambit of the trustees' investment powers;[257] the size of the trust fund; the expected duration of the trust; the benefits intended by the founder for the beneficiaries; the needs of the beneficiaries;[258] or the particular qualities and characteristics of the trustees.[259] According to De Waal, the trustees in *Estate Richards* were able to invest in the share market because the trust was intended to endure for a long period, the trustees were professional trustees, and the trust instrument included wide investment powers.[260]

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[251] Kunene (2001) *INS TAX* 3.

[252] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 553H and 558B-G.

[253] Kunene (2001) *INS TAX* 3; *Ex parte Van Hasselt* 1965 3 SA 422 (W) 425.

[254] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 558C-D.

[255] See para 3 1 above.

[256] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 557H.

[257] De Waal (1999) *TSAR* 376. For example, does the trust instrument afford the trustees wide investment powers?

[258] South African Law Commission *The Law of Trusts* Report 53-54.

[259] De Waal (1999) *TSAR* 377. For example, are the trustees professional trustees (eg employees of trustee corporations, attorneys or accountants) or non-professional trustees (eg family members or friends).

[260] 376-377.

General circumstances that must be considered include: the prevailing economic conditions,[261] for example, a high inflation rate;[262] the investment philosophy at the relevant time,[263] for example, an established industry practice of investing in equities to combat inflation;[264] and the need for diversified investment portfolios.[265]

With regard to the requirement that circumstances be taken into account, the decision in *Estate Richards* goes a step further than any other case previously decided by drawing attention to the fact that circumstances can change:[266]

> "But whether or not an investment can be said to have been prudent or made with due care and diligence is a question which can only be decided on the facts of each particular case …; *and circumstances change*." (Emphasis added.)

In the case of specific circumstances, for example, the needs of the beneficiaries can change over time or the original trustees can be replaced with more experienced or less experienced trustees. However, taken in context, when Scott JA referred to the fact that circumstances change, he was mainly referring to how general circumstances can change over time. For example, economic conditions such as the inflation rate can change. South Africa's economy has undergone substantial development and change since *Sackville* West has been decided. In 1925, inflation was non-existent.[267] In contrast, the issue of inflation was an important factor worth considering when *Estate Richards* was decided.[268] As discussed above, investing only in fixed-income investments when inflation is high will erode the capital invested in real terms.[269] Van der Reyden J in *Ex parte Ewing NO: In Re Sheridan*[270]

[261] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 557I; Cameron et al *Honoré's Law of Trusts* 352; J Mowbray, L Tucker, N le Poidevin, E Simpson & J Brightwell *Lewin on Trusts* 18 ed (2008) 1287 footnote 31.

[262] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 557I-J; De Mink (2004) *DR* 20.

[263] Mowbray et al *Lewin on Trusts* 1287 footnote 31.

[264] *Ex parte Van Hasselt* 1965 3 SA 422 (W) 424.

[265] Cameron et al *Honoré's Law of* Trusts 352; Mowbray et al *Lewin on Trusts* 1287.

[266] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 557I.

[267] *Ex parte Ewing NO: In Re Sheridan* 1995 2 SA 288 (D) 289.

[268] Kunene (2001) *INS TAX* 2.

[269] See para 3 2 above.

[270] 1995 2 SA 288 (D).

("*Ex parte Ewing*") stated that such a negative result could hardly have been intended by the Appellate Division in 1925.[271]

Investment philosophies can also change over time. Most institutions have developed an industry practice of investing in equities to combat inflation. In *Van Hasselt*, the evidence included a statement from an investment manager who wrote the following in 1961:[272]

> "…the great majority of institutions have become painfully aware of the demerits of monetary investments and have adopted a policy of placing a material proportion of their funds in real assets, usually either through the form of fixed property or the ordinary shares of public industrial, commercial, and mining companies. This change in policy has been common throughout the Western world and it is now rare for an insurance company, charitable institution, or pension fund to have no investments in real assets."

It can also be argued that the virtues of diversification were not appreciated in the first half of the century. For example, in *Sackville West*, the trustees invested in one investment only: a first mortgage of a certain hotel property;[273] and in *Ex parte Storm*, the trustees only made one investment: an investment in the shares of a public company.[274] In contrast, in *Van Hasselt*, the beneficiary's investments were spread over fifteen companies.[275]

The remark regarding the subject of "changing circumstances" is perhaps the most significant contribution to the development of trustee investing that the *Estate Richards* judgment makes. As discussed above, Scott JA showed that circumstances have indeed changed in the past few decades. More importantly, however, he indicated what the consequence of changed circumstances is: trustees are obligated to invest in "real assets with potential for capital growth" (eg listed shares/unit trusts) in order to protect trust assets from inflation and ensure the production of adequate income, particularly in the case of trusts intended to be of long duration.[276]

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[271] *Ex parte Ewing NO: In Re Sheridan* 1995 2 SA 288 (D) 289.

[272] *Ex parte Van Hasselt* 1965 3 SA 422 (W) 424.

[273] See para 2 2 1 above.

[274] See para 2 2 4 above.

[275] See para 2 2 9 above.

[276] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 556F, 588A and 558H.

A further significant aspect of the case to highlight is that through Scott JA's discussion of the consequence of changed circumstances, he also revealed the investment objective of modern trustees, namely that trustees are obliged to protect the real value of trust capital and must ensure the continued production of adequate income.[277] This is hereafter referred to as trustees' "main investment objective".

It is submitted that Scott JA did not alter the prudent and careful man rule; instead he provided much-needed clarification on how the rule should be applied by interpreting the rule in light of modern circumstances.

4 3 Criticism of the *Estate Richards* judgment

De Waal commends the decision in *Estate Richards* for heralding a more sophisticated and nuanced model of trusteeship, but suggests that the approach followed in the case is incompatible with the approach in *Sackville West*.[278] As discussed above, Scott JA could not find justification for a hard-and-fast rule that precluded the investment of trust funds in shares and unit trusts.[279] He also found that the ratio in *Sackville West* did not impose such a limitation on the investment of trust funds.[280]

The problem that De Waal has with the conclusion reached by Scott JA can be described as follows: Scott JA accepted that every investment in shares (and unit trusts) involves some element of risk. He further accepted that this element of risk is unavoidable if the capital of a trust is to be preserved in real terms.[281] In *Sackville West*, however, the need to avoid risks was emphasised in the judgments of both Solomon ACJ and Kotzé JA. Kotzé JA concluded that it is the duty of trustees not to expose trust funds to business risks in any way.[282] For De Waal, the approach in the *Sackville West* decision is crystal clear: an investment in a trust should in no way involve any risk.[283] Taking this seemingly contradictory approaches into

[277] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 556F; Geach *Trust Law* 224.

[278] De Waal (1999) *TSAR* 375 and 376.

[279] See para 4 1 above.

[280] See para 4 2 above.

[281] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 558B.

[282] *Sackville West v Nourse* 1925 AD 516 535-536.

[283] De Waal (1999) *TSAR* 376.

consideration, one can understand why De Waal is sceptical of Scott JA's statement that the two approaches are compatible.

However, the reason for considering Scott JA's conclusion as correct can be explained as follows: first, investing in the shares of a single company should be distinguished from investing in a share portfolio. The inherent risk of investing in the share market cannot be denied. It is this aspect that has given rise to the opinion that investing in shares or unit trusts is unsuitable for the funds of trusts.[284] This argument clearly has a certain force in the case of any one individual investment.[285] Even the most "azure of blue chip shares" is unprotected against the vagaries of the financial marketplace.[286] However, investing trust funds only in the shares of a single public company should be distinguished from investing in a well-spread portfolio of listed shares selected with care and kept under constant supervision by experts in the field. In *Van Hasselt*, Hiemstra J stated that the risk element of a portfolio of shares should not be exaggerated:[287]

> "To suggest that investment in a portfolio of shares *ipso facto* involves so much 'uncertainty and risk' that the whole undertaking automatically betrays lack of 'due care and diligence' is in my view unrealistic."

History has demonstrated that the capital value of a well-managed portfolio of listed shares and the income it produces will attain a remarkable degree of stability and growth over an indefinite period. In fact, it has conclusively been shown that such an investment provides a better long-term return than any fixed-rate investment.[288] The case for allowing fiduciaries to invest in a share portfolio has been put forcibly by Hiemstra J:[289]

> "The present issue remains to be whether operations on the stock exchange, spread over a substantial number of equities, and to be conducted by two persons with specialised knowledge, are to be regarded as so risky that the curator ought to shun Hollard Street

[284] De Mink (2004) *DR* 19.
[285] *Ex parte Van Hasselt* 1965 3 SA 422 (W) 425.
[286] *Ex parte Ewing NO: In Re Sheridan* 1995 2 SA 288 (D) 290.
[287] *Ex parte Van Hasselt* 1965 3 SA 422 (W) 425.
[288] 425; *Ex parte Ewing NO: In Re Sheridan* 1995 2 SA 288 (D) 289.
[289] *Ex parte Van Hasselt* 1965 3 SA 422 (W) 427.

when performing his duties. I do not think that one should, in the present circumstances, be overawed by the spectre of Black Friday."

Second, avoiding business risk does not mean that trustees should avoid every investment where the capital of the investment might decline in value.[290] Avoiding business risk would certainly include avoiding investing in a single asset with the potential of losing all its value. However, where individual shares can lose all their value, an investment portfolio containing a diversified portfolio of shares cannot[291] – especially if proper diversification has been taking place.[292] Thus, from a risk perspective, there is a significant difference between investing in the shares of a single company and investing in a properly diversified share portfolio.

Third, the *ratio* in *Sackville West* expressed no preference for a particular type of investment. Instead, whether an investment is proper or not is left to the discretion of the trustees.[293]

4 4 Relevant court cases decided after *Estate Richards*

It is worth discussing two subsequent cases that at first glance may appear to be more conservative decisions than the *Estate Richards* case.

4 4 1 Jowell v Bramwell-Jones

In *Jowell v Bramwell-Jones*[294] ("*Bramwell-Jones*"), the court was confronted with the scenario where the same person (the wife of the founder) was appointed as the trustee and sole income beneficiary of a trust. The founder's children were the capital beneficiaries. The founder's wife, the trustee, participated in a scheme that was alleged by the capital beneficiaries to have been affected in the interest of the trustee as income beneficiary only. The court found that the trustee had breached

[290] See para 2 3 1 above.

[291] I Shipway "Modern portfolio theory" (2009) 15 *T & T* 66 71.

[292] In other words, investments with offsetting risks have been chosen. For a detailed discussion of what constitutes "proper diversification", see chapter 3 para 3 1 4.

[293] See para 2 3 1 above.

[294] 2000 3 SA 274 (SCA).

her fiduciary duty.[295] However, it was held that the action was premature since it was not possible to establish whether a loss had been sustained.[296]

Scott JA *in casu* stated that "the vagaries of the share market are legion".[297] The context in which the court drew attention to the vagaries of the share market differs from that of *Estate Richards*. In the latter case, the fact that the share market is unpredictable was relevant because the question that had to be answered was whether it would be prudent for trustees to invest in riskier types of investment such as shares and unit trusts.[298] In *Bramwell-Jones*, on the other hand, the reference to the vagaries of the share market was relevant because it showed that the future values of investments of trust assets were uncertain and it was thus impossible to establish that there was going to be a loss in the future.[299]

4 4 2 Tijmstra NO v Blunt-Mackenzie

In *Tijmstra NO v Blunt-Mackenzie NO*[300] ("*Blunt-Mackenzie*"), one of the trustees deposited trust funds that had previously been invested in a safe investment in the joint account of himself and his wife.[301] The court held that the trustee could not be classified as a *bonus et diligens paterfamilias*.[302] Thus, he was removed from the office of trustee.[303]

According to Geach, the case makes it clear that the investment of trust funds must be made with safety and security, and it is not to be placed in "anything involving an element of uncertainty or risk".[304] However, it is important to determine what is meant by "risk" exactly. Risk in *Blunt-Mackenzie* does not refer to the possibility that the value of an investment might decrease in value because of market fluctuations. Instead, because the trustee invested the trust funds in his personal name and intermingled the funds with that of his wife, the trust funds were exposed

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295 Du Toit et al *South African Trust Law 132.*

296 Cameron et al *Honoré's Law of Trusts* 430.

297 *Jowell v Bramwell-Jones* 2000 3 SA 274 (SCA) paras 13 and 21.

298 See para 4 1 above.

299 *Jowell v Bramwell-Jones* 2000 3 SA 274 (SCA) para 21.

300 2002 1 SA 459 (T).

301 *Tijmstra NO v Blunt-Mackenzie NO* 2002 1 SA 459 (T) 474C-D.

302 474E.

303 474I.

304 Geach *Trust Law* 224.

to different types of risk – one being, for example, that all the trust funds might be lost if the trustee's or his wife's estate became sequestrated.

4 4 3 Conclusion reached regarding Bramwell-Jones and Blunt-Mackenzie

Although at first glance it may appear as if more conservative decisions were made than in the *Estate Richards* case, these decisions do not contradict any of the conclusions reached in *Estate Richards*.

5 Conclusion

In South Africa, the prudent and careful person rule governs how trustees should exercise their investment functions. The rule was enunciated in *Sackville West*, and in *Estate Richards* it was confirmed that the rule has not been departed from since.

For many years, trustees preferred to invest in so-called trust investments. This was not due to a court list approach operating in our law, but because there was a generally accepted practice amongst fiduciaries of preferring trust investments.

Perhaps the most significant contribution to the development of trustee investing that the *Estate Richards* judgment made is that it highlights the fact that circumstances change. The judgment further showed that circumstances had indeed changed since 1925 and revealed the consequence of changed circumstances, namely that trustees have to invest differently than in the past. To be more specific, in order to protect trust assets from inflation and ensure the production of adequate income, trustees are obligated to invest in real assets with the potential for capital growth (eg listed shares/unit trusts), particularly in the case of trusts intended to be of long duration.

Through his discussion of the consequence of changed circumstances, Scott JA also revealed that the main investment objective of trustees is to protect the real value of trust capital and to ensure the continued production of adequate income. This is referred to in this dissertation as trustees' main investment objective. It is important to note that what is expected from trustees in this instance corresponds with what is required from trustees under an investment rule based on MPT.[305]

This raises the following question: is it possible for trustees in South Africa to achieve their main investment objective without being able to rely an investment rule

[305] CB Schwartzel "Is the prudent investor good for Texas" (2002) 54 *Baylor LR* 701 717.

based on MPT? This question can only be answered by analysing the development of trustees' investment standards in the comparable foreign jurisdictions. If the answer to this question is no, it means that trustees cannot achieve their main investment objective if they are unable to rely on an investment rule based on MPT.

Before examining the development of trustees' investment standards in the three foreign jurisdictions, it is first necessary to obtain a basic understanding of MPT since the theory played a significant role in the reform that took place in these jurisdictions. Accordingly, the next chapter is devoted to an explanation of MPT.

CHAPTER 3 – MODERN PORTFOLIO THEORY

1 Introduction

This chapter introduces and explains modern portfolio theory ("MPT"). The purpose of the chapter is, first, to illustrate that MPT presents a better account of risk and safety than other popular models of investment behaviour, and second, that an investment strategy based on MPT is the best possible approach for people managing other people's assets.

As mentioned in the introductory chapter, in its simplest form, MPT is a theory of investment that "attempts to maximise portfolio expected return for a given amount of portfolio risk, or equivalently minimise risk for a given level of expected return, by carefully choosing the proportions of various assets".[1]

As one might expect, MPT is highly technical in structure. The chapter is not intended to provide a detailed account of all aspects and elements of the theory, but rather to provide a basic understanding of MPT. It is suggested that original sources should be consulted if one is interested in a rigorous proof of the elements of the theory.[2]

Following this introduction, the chapter is divided into five sections, which are summarised in the conclusion at the end of the chapter. Section 2 discusses the development of another popular investment strategy, namely focus portfolio theory ("FPT"), and explains its central features. Comparing MPT to another theory of investment management is a helpful way of gaining a better understanding of MPT. Section 3 details the development of MPT. Special attention is paid to the work of Harry Markowitz in the 1950s and the contributions of William Sharpe in the 1960s, as both their efforts were key to the development of the theory. Section 4 provides a summary of the theory's major lessons. Section 5 explains the implications of adhering to the tenets of MPT. Section 6 provides reasons for the necessity of involving professional investment managers when administering portfolios in accordance with MPT.

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[1] I Omisore, M Yusuf & N Christopher "The modern portfolio theory as an investment decision tool" (2012) 4 *J Account Taxation* 19 20.

[2] See eg HM Markowitz "Portfolio selection" (1952) 7 *J Finance* 77 and WF Sharpe "A simplified model for portfolio analysis" (1963) 9 *Manage Sci* 277.

2 Focus portfolio theory

As mentioned in the preceding paragraph, comparing MPT to FPT is a helpful way of gaining a better understanding of MPT. FPT is sometimes also referred to as value-oriented fundamental analysis,[3] the individual investment approach,[4] or value investing.[5] According to Athanassakos, FPT "cannot be more different" than MPT.[6] FPT was a popular approach prior to the development of MPT and remains a popular investment strategy today.[7]

FPT is a theory of investing developed by Ben Graham at Columbia University in New York in the early 1930s.[8] The famous investment expert, Warren Buffet, studied under Graham whereafter he worked for his mentor for two years from 1952.[9] Buffet has been extremely successful in using variations of Graham's model.[10]

According to Butler, FPT requires the investor to identify "those investment vehicles which are likely to perform best in the future, and then tells her to invest all of the available investment funds in those vehicles".[11] More precisely, FPT involves a three-step process:[12]

> "First, identify possibly undervalued stocks by choosing stocks with low price-to-earnings (P/E), price-to-book (P/B) or other valuation related metrics, second, value in depth the stocks that pass the screening process to estimate their intrinsic value and third, make an investment decision to buy only if the stock price is below the intrinsic value by a predetermined margin of safety …"

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[3] B Longstreth *Modern Investment Management and the Prudent Man Rule* (1986) 154.

[4] AS Butler "Modern portfolio theory and investment power of trustees: the New Zealand experience" (1995) 7 *Bond LR* 119 123.

[5] G Athanassakos "Value Investing vs. modern portfolio theory" (2012) 1 *J Bus & Fin Aff* 1 1.

[6] 1.

[7] Butler (1995) *Bond LR* 123-124; Longstreth *Modern Investment Management* 154.

[8] Athanassakos (2012) *J Bus & Fin Aff* 1; J Kuhle & SM Ogilby "Teaching the fundamental of Ben Graham and Warren Buffet" (2010) *Journal of Acad Bus Educ* 93 94.

[9] RG Hagstrom *The Warren Buffet Portfolio – Mastering the Power of the Focus Investment Strategy* (1999) 21.

[10] Kuhle & Ogilby (2010) *Journal of Acad Bus Educ* 94.

[11] Butler (1995) *Bond LR* 124.

[12] Athanassakos (2012) *J Bus & Fin Aff* 1.

FPT is grounded in the following set of beliefs: first, the market is not always efficient.[13] Thus, "focus investors" assume that the market sometimes misprices investments.[14] Hence, they believe that through careful research they will be able to recognise such mispricing, affording them opportunities to outperform the market.[15] Second, focus investors define risk as "valuation risk", which is paying too much for a particular stock.[16] According to Hagstrom, the risk for an investor who misjudges the value of the shares of a company listed on a stock exchange is that the investment might not give the investor "at least as much purchasing power as he had to begin with, plus a modest rate of interest on that initial stake".[17] Third, focus investors believe that the less diversified a portfolio is, the better it will perform. In other words, FPT entails concentrating a portfolio to a few selected truly undervalued stocks.[18] Hagstrom provides the reason why focus investors are unconcerned with portfolio diversification:[19]

> "… by purposely focusing on just a few select companies, you are better able to study them closely and understand their intrinsic value. The more knowledge you have about your company, the less risk you are likely to be taking."

And Loeb expressed it as:[20]

> "…once you attain competence, diversification is undesirable."

The remainder of the chapter shows that MPT presents completely different views than FPT concerning the likelihood of outperforming the market, the meaning of the term "risk", and the importance of diversification.

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[13] Hagstrom*The Warren Buffet Portfolio* 34. For a discussion of market efficiency, see para 3 4 below.

[14] B Goodall *Investment Planning* (2017) part 2 para 1.8.

[15] Hagstrom*The Warren Buffet Portfolio* 34; Longstreth *Modern Investment Management* 154.

[16] Athanassakos (2012) *J Bus & Fin Aff* 1.

[17] Hagstrom *The Warren Buffet Portfolio* 30.

[18] Athanassakos (2012) *J Bus & Fin Aff* 1.

[19] Hagstrom *The Warren Buffet Portfolio* 32.

[20] GM Loeb *The Battle for Investment Survival* (1935) 42.

3 The development of MPT

Throughout the 1950s and 1960s, MPT was of consuming interest to theorists and researchers. Investment managers, on the other hand, paid little attention to the theory since portfolio management was uncharted territory. However, by the 1970s, this all changed. The downward spiral of the United States stock market in the early 1970s forced investment managers to take the writings coming from major universities seriously and consider the possibility that there might be better ways of managing investment portfolios. By the late 1970s, it had become commonplace for investment managers to apply MPT.[21]

3 1 Markowitz's contribution

MPT is traceable to a landmark paper by Harry Markowitz entitled "Portfolio selection" published in the Journal of Finance in 1952.[22] Markowitz's insights ultimately won him the Nobel Prize in Economic Sciences.[23] Although pioneered by Markowitz in the 1950s, the theory was furthered by William Sharpe in the 1960s.[24]

Markowitz proposes that in designing a portfolio, an investor should look to the risk of his portfolio as well as its return.[25] In order to understand Markowitz's thinking, the concept of "expected return" and the concept of "risk" must be explained first.

3 1 1 The concept of expected return

The expected return of an investment is calculated by "multiplying every possible return by its probability of being the actual return, and then adding up the results of the multiplication".[26] To illustrate, assume that there is a 50% probability that a particular stock, the price of which is R10 today, will be worth R12 one year from now, a 40% probability that it will be worth R15, and a 10% probability that it will be

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[21] Hagstrom *The Warren Buffet Portfolio* 28.

[22] Markowitz (1952) *J Finance*.

[23] SE Sterk "Rethinking trust law reform: how prudent is modern prudent investor doctrine" (2010) 95 *Cornell LR* 851 858.

[24] See para 3 2 below.

[25] HM Markowitz "The early history of portfolio theory" (1999) 55 *FAJ* 5 5.

[26] JH Langbein & RA Posner "Market funds and trust-investment law" (1976) 1 *Am B Found Res J* 1 7.

worth R0.[27] Consequently, there is a 50% probability of a R2 return, a 40% probability of a R5 return, and a 10% probability of a -R10 return. The expected return is thus R2.[28] Measured as a percentage of the original price of the share,[29] the expected return is 20%.[30]

It is also possible to calculate the return of a portfolio consisting of one, two, or many investments. The expected return of a portfolio is simply the weighted average return of the individual assets that make up the portfolio.[31]

In addition, MPT defines what constitutes return using the concept of "total return". Total return includes both cash flow to the investor and changes in market value.[32] For stocks, return consists of both dividends and capital gains;[33] while for bonds, return consists of interest paid plus the change in price.[34]

3 1 2 The concept of risk

In finance, risk is defined as "the variance from the potential or expected outcome of an investment".[35] Accordingly, risk does not refer to its more informal meaning of "the chance that something bad will happen".[36] Hereafter, the use of the term "risk" is restricted to its connotative meaning in financial theory, unless otherwise specified.

The degree of variance can be calculated mathematically. The variance of an investment equals the probability-weighted average of squared deviations from the expected value.[37] Alternatively, standard deviation can be used as a measure of risk.

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[27] Based on Langbein & Posner's illustration: Langbein & Posner (1976) *Am B Found Res J* 7.

[28] (0.5 × R2) + (0.4 × R5) − (0.1 × R10) = R2

[29] HE Bines "Modern portfolio theory and investment management law: refinement of legal doctrine" (1976) 76 *Columbia LR* 721 751.

[30] 2 / 10 = 0.2.

[31] Butler (1995) *Bond LR* 123.

[32] MD Begleiter "Does the prudent investor need the Uniform Prudent Investor Act – an empirical study of trust investment practices" (1999) 51 *Maine LR* 27 59; EJ Elton & JG Gruber "The lessons of modern portfolio theory" in B Longstreth *Modern Investment Management and the Prudent Man Rule* (1986) 161 162.

[33] Langbein & Posner (1976) *Am B Found Res J* 7.

[34] Elton & Gruber "The lessons of modern portfolio theory" in Longstreth *Modern Investment Management* 162.

[35] Begleiter (1999) *Maine LR* 33.

[36] Butler (1995) *Bond LR* 122 footnote 11.

[37] CP Cline *The Law of Trustee Investments* (2009) 23.

Standard deviation is the square root of variance. Either variance or standard deviation can be employed to measure risk; which of the two is used is solely a matter of convenience. A ranking of investments by variance will be identical to a ranking by standard deviation.[38] Since standard deviation is in the same units as an investment's rate of return, it is generally more convenient to use standard deviation.[39]

An investment with a high standard deviation is described as having a high volatility because it has a greater probability of uncertain returns, whereas an investment with a low standard deviation is described as having low volatility.[40] Risk management requires careful attention to a particular investor's tolerance for volatility.[41] All things being equal, it is better to invest in a stock with a lower volatility. To illustrate this point, consider the following example:[42]

> Assume that an investment of R100 is made in two investments; one rises and falls in value by 50% each year while the other neither increases nor decreases. The first investment increases 50% after one year and is worth R150, but in year two, falls in value to R75 and so on. After four years, this investment will be worth about R56 while the other investment will still be worth R100. Both have an average annual return of zero, but the more volatile investment has fallen in value.

3 1 3 Determining the riskiness of an investment portfolio

As mentioned in paragraph 3 1 above, Markowitz proposes that in designing a portfolio, an investor should be interested in the risk of the portfolio as well as its expected return:[43]

> "My 1952 article on portfolio selection proposed expected (mean) return, *E*, and variance of return, *V*, of the portfolio as a whole as criteria for portfolio selection …"

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[38] RD Blair & AA Heggestad "The prudent man rule and preservation of trust principle" (1978) 1 *L F* 79 80 footnote 3.

[39] Cline *Trustee Investments* 23.

[40] I Shipway "Modern portfolio theory" (2009) 15 *T & T* 66 68.

[41] EC Halbach "Trust investment law in the Third Restatement" (1992) 27 *Real Prop Prob & Tr J* 407 436 footnote 98.

[42] Based on Shipway's example: Shipway (2009) *T & T* 68.

[43] Markowitz (1999) *FAJ* 5.

Markowitz's statement might appear remarkably self-evident. According to Hagstrom, however, it was a revolutionary concept in the 1950s:[44]

> "Until that time, investors gave very little thought to managing a portfolio or to the concept of risk. Portfolios were constructed haphazardly. If a manager thought a stock was going to go up in price, it was simply added to the portfolio. No other thinking was required."

Support for this statement can be found in Markowitz's 1952 article:[45]

> "There is a rule which implies both that the investor should diversify and that he should maximize expected return. The rule states that the investor does (or should) diversify his funds among all those securities which give maximum expected return."

According to Markowitz, the strategy of investing in securities that provide the greatest return lacked "a measure of risk".[46] In other words, what was missing was a way of determining the riskiness of an entire investment portfolio. So, Markowitz found a way of calculating *the riskiness* of the *portfolio as a whole.* The method Markowitz chose for determining the riskiness of an entire investment portfolio was "co-variance".[47] This method requires explaining.

As already discussed, a portfolio's return is equal to the weighted average return of its individual assets.[48] The procedure for determining the expected standard deviation of portfolio returns is, however, more complex. One might think the riskiness of a portfolio is simply the weighted average variance of all the individual stocks in the portfolio. While variance may provide a gauge regarding the riskiness of an individual stock, the average of two variances does not provide a measure for the riskiness of a two-stock portfolio. The variance and, therefore, the standard deviation of a portfolio is not merely the sum of the variances of the individual stocks that make up the portfolio.[49] The solution is co-variance. Co-variance is a statistical

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[44] Hagstrom *The Warren Buffet Portfolio* 23.

[45] Markowitz (1952) *J Finance* 79.

[46] Markowitz (1999) *FAJ* 8.

[47] 8: "…variance came to mind. On examining the formula for the variance of a weighted sum of random variables …, I was elated to see the way co-variances entered".

[48] See para 3 1 1 above.

[49] Butler (1995) *Bond LR* 122.

measure of how one investment moves in relation to another.[50] If two investments tend to be up or down during the same time periods, then the two investments have positive co-variance.[51] If the highs and lows of one investment move in perfect coincidence to that of another investment, then the two investments have perfect positive co-variance. In the extreme case of perfect positive co-variance, the standard deviation of the portfolio will simply be the weighted average of the two investments.[52] If one investment tends to rise in value at the same time as another falls in value, then the two investments have negative co-variance.[53] One could also say that the two investments are negatively correlated.[54] If there is no discernible pattern to the up-and-down cycles of one investment compared with another, then the two investments have no co-variance.

By combining investments that do not go up and down in value at the same time as one another, one can reduce the risk of a portfolio. To appreciate this statement, consider the following familiar example:[55]

> Assume that an investor has the opportunity to invest in two businesses – one that sells suntan lotion and the other umbrellas. If the investor decides only to invest in the suntan lotion manufacturer, he will do well when the sun is shining but not so well when it is raining. Conversely, if the investor only purchases shares in the umbrella manufacturer, he will suffer a fall in the value of his investment during sunny periods, but experience a rise during rainy periods. Now consider what will happen if the investor invests half of his money in the suntan lotion manufacturer and the other half in the umbrella manufacturer. The value of the combined portfolio will not suffer the ups and downs of the individual holdings; the ups and downs will cancel each other out. Abnormally sunny or rainy weather will enhance one manufacturer's profits even while it hurts the other manufacturer's profits. The investor's overall return will thus be the same as when investing all his money in one or the other.

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[50] Levy "The prudent investor rule: theories and evidence" (1994) 1 *Geo Mason U LR* 1 13; B Goodall, L Rossini, M Botha, W Geach & L du Preez *The South African Financial Planning Handbook* (2017) para 21.6.

[51] Shipway (2009) *T & T* 68.

[52] Blair & Heggestad (1978) *L F* 91.

[53] Shipway (2009) *T & T* 68.

[54] Butler (1995) *Bond LR* 122.

[55] This example is a combination of Shipway's deckchairs/umbrellas and Gordon's suntan lotion/umbrellas examples: Shipway (2009) *T & T* 68 and JN Gordon "The puzzling persistence of the constrained prudent man rule" (1987) 62 *N Y U LR* 52 54-55.

The normalised version of co-variance, namely the correlation coefficient, ranges from −1 to +1, and denotes the correlation between the returns on two assets.[56] Combining assets that have a low correlation with each other will produce a portfolio with a lower standard deviation than either of the individual assets. An example might be instructive. Levy, an American academic, provides the following example:[57]

> "The correlation coefficient between long-term government bonds and small capitalization stocks over the 10-year period ended June 30, 1992 was 0.155; the respective annualized standard deviations for these two assets were 11.8% and 21.4% (ie small capitalization stocks were nearly twice as volatile as long-term government bonds). Since the correlation is fairly low, combining the assets should stabilize return. In fact, the standard deviation of a portfolio allocated two-thirds to long-term government bonds and one-third to small capitalization stocks would be 11.2%."

3 1 4 Conclusion

Markowitz points out that it is not simply the number of different stocks that investors own that matters.[58] Rather, when making portfolio decisions, investors should consider the relationship between the rate of return pattern of each asset versus each other asset in a portfolio.[59] From Markowitz's standpoint, in order to reduce a portfolio's risk, investors should combine investments that do not go up and down in value at the same time as each other. In more technical terms, what is required is that the investments in a portfolio should have a low co-variance with each other.[60] Markowitz thus not only encourages diversification, but argues for the "right kind" of diversification.[61] Ruce refers to this type of diversification as "proper diversification".[62] An important point to highlight is that proper diversification reduces

[56] Levy (1994) *Geo Mason U LR* 13; Goodall et al *Financial Planning Handbook* para 21.6.

[57] Levy (1994) *Geo Mason U LR* 13.

[58] Markowitz (1952) *J Finance* 89.

[59] EA Moses, JC Singleton & SA Marshall "Modern portfolio theory and the Prudent Investor Act" (2004) 30 *ACTEC LJ* 165 167.

[60] Markowitz (1999) *FAJ* 8.

[61] Markowitz (1952) *J Finance* 89.

[62] PJ Ruce "The trustee and the prudent investor: the emerging acceptance of alternative investments as the new fiduciary standard" (2012) 53 *South Texas LR* 653 667.

a portfolio's overall risk without reducing the anticipated return rate of the portfolio as a whole.[63]

3 2 Sharpe's contribution

3 2 1 A simpler version of the Markowitz's model

The problem with Markowitz's model as a practical matter, however, is that it requires countless co-variant calculations.[64] Where the number of stocks in a portfolio increases beyond two, it becomes difficult to calculate the co-variances between each set of stocks. According to Levy, with only 100 stocks there are 4 950 pairs of co-variances to be considered.[65] Fortunately, Sharpe developed a simpler version of Markowitz's model.

In 1963, Sharpe published his dissertation titled: "A simplified model of portfolio analysis".[66] He suggested that instead of calculating the co-variances between each set of stocks, one only has to calculate the relationship between each security and some underlying base factor.[67] For Sharpe the underlying base factor was the market as a whole.[68] Sharpe's volatility measure will be referred to as "beta". Beta, also known as the beta coefficient,[69] measures how volatile an investment or portfolio is compared to the overall market.[70] Stocks that rise and fall in value exactly in line with the market are assigned a beta of 1.0.[71] Thus, a stock with a beta of 1.0 moves up 10% when the market moves up 10% (and down 10% when the market moves down 10%).[72]

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[63] Halbach (1992) *Real Prop Prob & Tr J* 433; Butler (1995) *Bond LR* 123.

[64] Bines (1976) *Columbia LR* 795.

[65] Levy (1994) *Geo Mason U LR* 14.

[66] Sharpe (1963) *Manage* Sci.

[67] Levy (1994) *Geo Mason U LR* 15.

[68] Bines (1976) *Columbia LR* 795.

[69] FP Manns "New Zealand trustee investing: reflecting on modern portfolio theory and the ancient distinction of principle and income" (1998) 28 *Victoria U Wellington LR* 611 623.

[70] Elton & Gruber "The lessons of modern portfolio theory" in Longstreth *Modern Investment Management* 170.

[71] Begleiter (1999) *Maine LR* 37 footnote 99.

[72] Langbein & Posner (1976) *Am B Found Res J* 10.

A portfolio's beta is simply the weighted average of the betas of the stocks within the portfolio.[73] Knowledge of the portfolio's beta informs an investor of the riskiness of the portfolio.[74] Any portfolio with a beta of less than 1.0 means the portfolio is less risky than the market as a whole. Similarly, a portfolio with a beta of more than 1.0 is riskier than the market.

3 2 2 Systematic and unsystematic risk

The other major contribution that Sharpe made to MPT was to introduce a far-reaching concept called the capital asset pricing model ("CAPM").[75] According to the CAPM, it is preferable to separate risk into two components.[76] Sharpe terms the first component "systematic risk",[77] and the second component "unsystematic risk".[78] Systematic risk, also known as "market risk", is the risk common to all securities and reflects general economic, political and social conditions.[79] The systematic risk of a stock or a portfolio is measured by its beta.[80] The other component of risk, namely unsystematic risk (also known as "non-market risk",[81] "unique risk",[82] "residual risk",[83] "independent risk",[84] or "firm-specific risk"[85]), refers to the risk that surrounds an

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[73] Bines (1976) *Columbia LR* 756.

[74] Begleiter (1999) *Maine LR* 37 footnote 99.

[75] Independently developed by Sharpe, John Lintner, and Jan Mossin, the model is sometimes referred to as the Sharpe-Lintner-Mossin capital asset pricing model in honour of its discoverers: Elton & Gruber "The lessons of modern portfolio theory" in Longstreth *Modern Investment Management* 169.

[76] Levy (1994) *Geo Mason U LR* 15.

[77] WF Sharpe "Capital asset prices: a theory of market equilibrium under conditions of risk" (1964) 19 *J Finance* 425 436.

[78] 439.

[79] Begleiter (1999) *Maine LR* 33-34; CB Schwartzel "Is the prudent investor good for Texas" (2002) 54 *Baylor LR* 701 720: "Changes in economic, political and social conditions, such as changes in monetary policy by the Federal Reserve and general economic downturns, affect all investments more or less indiscriminately …"

[80] Begleiter (1999) *Maine LR* 34 footnote 74.

[81] Levy (1994) *Geo Mason U LR* 16.

[82] Butler (1995) *Bond LR* 123.

[83] Elton & Gruber "The lessons of modern portfolio theory" in Longstreth *Modern Investment Management* 173.

[84] JV Rizzi "Trustees investment powers: imprudent application of the prudent man rule" (1975) 50 *Notre Dame Law* 519 524.

individual security and is peculiar to that security. For example, a company's profitability can be affected by "the loss of an important customer, by the unexpected death of a senior executive, by litigation or regulatory problems, by labour strikes, or other events unique to that company".[86]

Systematic risk cannot be diversified away within a market.[87] In view of this, systematic risk is also known as "undiversifiable risk".[88] Unsystematic risk, by contrast, can be reduced greatly through diversification.[89] Hence, unsystematic risk is sometimes called "diversifiable risk".[90] By diversifying their portfolios, investors can theoretically reduce all unsystematic risk, since stocks do not react to events in the same way.[91] According to the CAPM, since investors do not have to bear unsystematic risk, they are not automatically compensated by higher returns in the marketplace for incurring the extra risk.[92] To illustrate this point, consider the following example by Manns:[93]

> "The rate of return of a company's shares is the same for all investors for the same period of time; those who own only Telecom are not rewarded with a higher rate of return on their Telecom shares compared to those Telecom shareholders who also own shares in other companies."

3 3 A sensible strategy for risk averse investors

MPT generally assumes that investors are "risk averse".[94] This assumption of risk aversion is probably realistic for most investors.[95] According to Langbein and

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[85] Begleiter (1999) *Maine LR* 36.

[86] Schwartzel (2002) *Baylor LR* 720.

[87] Sterk (2010) *Cornell LR* 859; Manns (1998) *Victoria U Wellington LR* 622. Systematic risk can, however, be mitigated through using the right asset allocation strategy: see para 5 2 below.

[88] Langbein & Posner (1976) *Am B Found Res J* 12-13.

[89] JH Langbein "The Uniform Prudent Investor Act and the future of trust investing" (1996) 81 *Iowa LR* 641 648.

[90] Begleiter (1999) *Maine LR* 33.

[91] Bines (1976) *Columbia LR* 752.

[92] Levy (1994) *Geo Mason U LR* 16; Bines (1976) *Columbia LR* 753.

[93] Manns (1998) *Victoria U Wellington LR* 622.

[94] G Moffat *Trust Law Text and Materials* 5 ed (2009) 481.

[95] Butler (1995) *Bond LR* 122; Halbach (1992) *Real Prop Prob & Tr J* 423; Begleiter (1999) *Maine LR* 33; DL Maginn, DW Tuttle, JE McLeavey & JL Pinto *Managing Investment Portfolios – A Dynamic Process* 3 ed (2007) 767.

Posner, risk aversion should even be more prevalent among trustees managing trust assets for the benefit of trust beneficiaries than among individual investors generally.[96] Bines shares Langbein and Posner's belief since he states that people managing other people's assets are legally obligated to be risk averse.[97]

Risk aversion does not mean that investors do not want to take any risk. Rather, it means that given two investments that offer the same level of return, investors will generally choose the less risky investment.[98] Moreover, a *risk averse investor* will take on increased risk only if he is compensated by an appropriate increase in expected return,[99] or any additional risk is justified by a lower price.[100]

By diversifying his portfolio, an investor can theoretically reduce all unsystematic risk.[101] The only risk remaining in the portfolio will be systematic risk.[102] In contrast, there will be systematic risk *and* unsystematic risk in a non-diversified portfolio. The risk of a non-diversified portfolio will thus be higher than a diversified portfolio.[103] Conversely, the risk of a diversified portfolio will be lower than that of a non-diversified portfolio. Consequently, a risk averse investor would diversify his portfolio.[104]

Applying these rules to a portfolio of investments, an investor will endeavour to construct a portfolio containing assets that provide the lowest level of risk for a given rate of return or,[105] alternatively, the highest rate of return for a given level of risk.[106] This is the so-called "efficient portfolio". In an efficient portfolio, an investor will have

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[96] JH Langbein & RA Posner "Market funds and trust-investment law II" (1977) 2 *Am B Found Res J* 1 3.

[97] Bines (1976) *Columbia LR* 759.

[98] Begleiter (1999) *Maine LR* 33.

[99] Maginn et al *Managing Investment Portfolios* 767: "A widely accepted principle of investment management theory and practice is that investors are risk averse and therefore require additional expected return to compensate for increased risk".

[100] Butler (1995) 7 *Bond LR* 122.

[101] See para 3 2 2 above.

[102] Begleiter (1999) *Maine LR* 34.

[103] Bines (1976) *Columbia LR* 753: "… unsystematic risk always raises portfolio risk above systematic risk …".

[104] Begleiter (1999) *Maine LR* 34.

[105] Blair & Heggestad (1978) *L F* 80-81.

[106] Maginn et al *Managing Investment Portfolios* 257.

to accept additional risk to obtain a higher return,[107] or give up returns to reduce the riskiness of the portfolio.[108] According to Begleiter, there is an infinite number of efficient portfolios depending on the investor's choice of risk or rate of return.[109] Investors will select their optimal portfolios based on their tolerances for risk.[110]

Efficient portfolios plot graphically on the efficient frontier.[111] The efficient frontier can be thought of as "a line in a graph, one axis of which is risk assumed and the other of which is return generated".[112] This line represents the best possible combination from a range of assets.[113] Any portfolio below the line is less than optimal.[114] Therefore, risk averse investors should only want to hold efficient portfolios.[115]

3 4 The implication of the efficient capital market hypothesis

The efficient capital market hypothesis ("ECMH") is an idea partly developed by Eugene Fama.[116] It is a particularly important concept, which is often coupled with MPT.[117] The ECMH states that a market is efficient if the prices of securities in that market fully reflect all available information.[118] In an efficient market, the prices of securities adjust quickly and in an unbiased manner to new information.[119] Fama distinguishes between three forms of market efficiency:[120]

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107 Elton & Gruber "The lessons of modern portfolio theory" in Longstreth *Modern Investment Management* 162.

108 Cline *Trustee Investments* (2009) 24.

109 Begleiter (1999) *Maine LR* 35.

110 35.

111 Maginn et al *Managing Investment Portfolios* 257.

112 Cline *Trustee Investments* 24.

113 Shipway (2009) *T & T* 70.

114 Cline *Trustee Investments* 24.

115 Blair & Heggestad (1978) *L F* 80.

116 See EF Fama "Efficient capital markets: a review of theory and empirical work" (1969) 25 *J Finance* 383-417; Hagstrom *The Warren Buffet Portfolio* 27: "Although several other distinguished researchers have written about efficient markets …, Fama is most credited with developing a comprehensive theory of the behaviour of the stock market".

117 Butler (1995) *Bond LR* 125.

118 Begleiter (1999) *Maine LR* 37.

119 Goodall *Investment Planning* part 2 para 1.7.

120 Begleiter (1999) *Maine LR* 37-38; Butler (1995) *Bond LR* 126.

The strong form – both public and insider information are built into a security's price.

The semi-strong form – all publicly available information is built into a security's price.

The weak form – only historical performance is built into a security's price.

According to professors RW Vivian and C Auret from the University of the Witwatersrand, empirical evidence differentiates the JSE as a "semi-strong efficient market".

It is important to note that not all markets that may interest an investor will necessarily approximate closely to the efficiency model. The major areas where the markets are less efficient include: real estate; venture capital; foreign securities; financial derivatives such as managed futures; private equity; and hedged funds.[121]

The ECMH has important implications for the conduct of investors. Supporters of the hypothesis believe that it is extremely difficult to "beat the market" (ie trying to earn a return greater than that of the market as a whole) consistently over an extended period of time.[122] Begleiter explains why it is so difficult to outperform the market consistently:[123]

> "The reason for this is that to locate undervalued stocks, the investor must consistently discover information about companies that is not generally known. The ECMH says this is impossible because by the time such information is discovered, it has already been reflected in the price of the stock."

The implication of the ECMH taken together with MPT is that a prudent investor will follow a passive investment approach in an efficient market.[124] Passive investing is discussed in paragraph 5 below.

4 The lessons of MPT

At the centre of MPT are a number of key lessons: first, MPT defines what constitutes return using the concept of total return.[125] The significance of this definition of return is that it gives people managing investment portfolios "greater

[121] Begleiter (1999) *Maine LR* 63; Butler (1995) *Bond LR* 126-127.

[122] Goodall *Investment Planning* part 2 para 1.8.

[123] Begleiter (1999) *Maine LR* 37.

[124] 38.

[125] See para 3 1 1 above.

flexibility in assessing trade-offs between risk and reward by providing a much broader view of what constitutes return and, consequently, what justifies increased risks for the portfolio".[126]

Second, MPT teaches that the proper focus is on the "total portfolio".[127] In contrast, proponents of FPT examine investments individually, build up portfolios of favoured stocks, and do not consider how the stocks in their portfolios relate to each other.[128] MPT departs from this strategy by shifting emphasis from analysing the characteristics of individual investments to determining the statistical relationships among the individual stocks that comprise the overall portfolio. Markowitz shows that it is not simply the number of different stocks an investor owns that matters, but, rather, that it is the correlation of those stocks with one another that matters.[129] Therefore, the riskiness of a portfolio depends on the co-variance of its holdings and not on the average riskiness of the separate investments.[130] Accordingly, decisions as to the particular investments included in the portfolio must be made by considering the role each investment plays in the whole portfolio. It is important to note that such decisions cannot be made in isolation.[131]

Third, according to MPT, no asset or investment technique is inherently good or bad or prohibited *per se* as too risky.[132] MPT's focused attention on the portfolio as a whole means that injecting an asset that is highly volatile in itself into a portfolio is not necessarily illogical.[133] Intuitively, it is not obvious that adding high-risk stocks (eg small capitalisation stocks) to a portfolio of low-risk investments (eg government bonds) would make the portfolio less risky than a portfolio composed entirely of low-risk investments. But, as seen above, it is possible to reduce a portfolio's risk by adding an asset that moves inversely to the other investments of the portfolio.[134]

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[126] WB Phillips "Chasing down the devil: standards of prudent investment under the Restatement (Third) of Trusts" (1997) 54 *Wash & Lee LR* 335 355.

[127] Begleiter (1999) *Maine LR* 58.

[128] Butler (1995) *Bond LR* 123-124.

[129] GC Curtis "Modern portfolio theory and behavioural finance" (2004) *J Wealth Manag* 16 16; see also para 3 1 4 above.

[130] Butler (1995) *Bond LR* 122.

[131] Moses et al (2004) *ACTEC LJ* 167.

[132] Begleiter (1999) *Maine LR* 35.

[133] Goodall et al *Financial Planning Handbook* para 21.6.

[134] See para 3 1 3 above.

MPT thus teaches that the true economic measure of a stock's risk is its contribution to portfolio risk.

Fourth, diversification is essential to the management of risk. The purpose of diversification is to reduce the unsystematic risk in a portfolio by investing in stocks that move in different ways in relation to one another. The only risk that will remain in the portfolio is systematic risk. Consequently, the volatility of a properly diversified portfolio will be lower than one that is not diversified. Importantly, this is achieved without lowering return expectations.[135]

5 The implications of adhering to the tenets of MPT

The major insight offered by MPT is that risks specific to an investment in any particular company may be virtually eliminated by holding a diverse portfolio of shares in other companies. As a result, the volatility of a properly diversified portfolio will be lower than one that is not diversified. Since there is no compensation for taking on extra risk, MPT indicates that investors should eliminate it.[136]

Consequently, one of the strongest implications for an investor who adheres to the principles of MPT is that the investor will hold the "market portfolio".[137] The hypothetical market portfolio represents the aggregate of all risky assets. For example, "if IBM represents one percent of all risky assets it represents one percent of the market portfolio".[138] The beta of the market portfolio is 1.0.[139]

An appropriate step for an investor who wants to construct a portfolio that is near-perfectly correlated with the market portfolio would be to place his funds in an index fund tracking a market index. These terms require clarification. *An index fund* is designed to match or track the components of an established index of stocks or some other investment type (eg fixed-income investments).[140] *A market index* is intended to represent an entire stock market. For example, a market index such as the Standard & Poor's 500 index ("S&P 500") is a broad representation of the United

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[135] See paras 3 1 4 and 3 2 2 above.

[136] See para 3 2 2 above.

[137] Levy (1994) *Geo Mason U LR* 10.

[138] Elton & Gruber "The lessons of modern portfolio theory" in Longstreth *Modern Investment Management* 170.

[139] Langbein & Posner (1976) *Am B Found Res J* 12.

[140] Anonymous "Index investing" (01-11-2017) *Investopedia* <https://www.investopedia.com/terms/i/index-investing.asp> (accessed 21-11-2017).

States equity market.[141] Typically, an index fund tracking a market index will contain all the securities covered by the market index in the same relative weight as their weight in the index. Hereafter, an index fund that is constructed to approximate the performance of a market index will be referred to as a "market index fund".[142]

A market index fund provides low operating expenses and low portfolio turnover.[143] Investing in such a fund is regarded as a passive investment strategy. A passive investment strategy requires minimal input from the investor, relies on diversification, and buys many stocks in the same market to match the performance of a market index.[144] In South Africa, investors can access index-tracking strategies either via unit trusts or exchange-traded funds ("ETFs").[145]

The aim of an investment in a market index fund is to generate the same expected return as a market portfolio. In other words, the investor expects the market rate of return.[146] The question then becomes: what if the investor desires a higher expected return than that of the market as a whole or wishes to adjust portfolio risk downwards?

5 1 Increasing expected return

One method for an investor to increase the expected return of his portfolio is to cast out less risky stocks until the average beta of the remaining stocks is 2.0.[147] However, trying to increase the expected return by increasing the concentration in riskier securities in a portfolio is inefficient, because it introduces diversifiable risk into the portfolio.[148]

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[141] Levy (1994) *Geo Mason U LR* 17.

[142] Begleiter (1999) *Maine LR* 63.

[143] 63: "Because the fund only buys or sells a security when a significant change in the price of the security occurs or when an investment is added to or dropped from the index measuring the fund, index funds have a 'buy and hold' strategy which insures low transaction costs".

[144] Omisore et al (2012) *J Account Taxation* 20.

[145] M Brown & N Visser "The 'real guide' to index tracking products in South Africa – unit trusts vs exchange traded products" (02-12-2015) *FAnews* <https://www.fanews.co.za/article/investments/8/etf-s-exchange-traded-funds/1132/the-real-guide-to-index-tracking-products-in-south-africa-unit-trusts-vs-exchange-traded-products/19418> (accessed 10-11-2017).

[146] Bines (1976) *Columbia LR* 754; Manns (1998) *Victoria U Wellington LR* 622.

[147] Langbein & Posner (1976) *Am B Found Res J* 13.

[148] Elton & Gruber "The lessons of modern portfolio theory" in Longstreth *Modern Investment Management* 173.

According to MPT, an increase in expected return is rather obtained by increasing exposure to market risk.[149] So how does one increase exposure to market risk? The answer is that it is accomplished through leverage.[150] By borrowing money to buy additional stocks, an investor can increase expected return without sacrificing any diversification.[151] For example:[152]

> Suppose an investor has funds of R500 000. The investor borrows an additional R500 000, thus giving him R1 000 000 that he invests in a market index fund. He pays 9% interest on the loan and the expected return on the market index fund is 12%. However, by using leverage, the expected rate of return on his portfolio increases to 15%.[153]

In the present example, the expected return after using leverage is higher than the return on the market index fund alone, but the beta of the investor's portfolio is higher than the market index fund's beta too. If, for example, the market declined by 10%, the portfolio would be worth R900 000. Since the investor still owes R500 000 to the lender, his net assets would be only R400 000. That is 20% less than before the decline of the market. The portfolio's beta is thus 2.0.[154] Langbein and Posner admit that leverage intensifies a portfolio's reaction to events and increases its level of risk.[155] However, they defend such a strategy with the following comparison:[156]

> "Indeed, the difference between the market portfolio levered to a beta of 1.5 and the individual stock having a beta of 1.5 is of almost metaphysical subtlety, since very often the reason a stock has a high beta is precisely that the company issuing it is highly levered (i.e., has a high proportion of debt in its capital structure)."

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[149] Rizzi (1975) *Notre Dame Law* 525.

[150] 525 footnote 57.

[151] Levy (1994) *Geo Mason U LR* 16.

[152] This is a modified version of Langbein and Posner's example: Langbein & Posner (1976) *Am B Found Res J* 13.

[153] The expected return of the portfolio is calculated as follows: R120 000 (0.12 × R1 000 000) minus interest costs R45 000 (0.9 × R500 000), divided by R500 000 (the original value of the portfolio). Thus, R75 000 / R500 000 = 0.15.

[154] Langbein & Posner (1976) *Am B Found Res J* 13.

[155] 33.

[156] 33.

5 2 Adjusting risk downward

An investor could also consider adjusting his risk downward. Suppose an investor wants half as much risk as the market as a whole exhibits (ie a portfolio that will have a beta of 0.5). As risk and return are inextricably linked,[157] the investor must be willing to accept a lower return in exchange for less volatility.[158]

One method is to do away with riskier stocks until the average beta of the remaining stocks in the portfolio is 0.5.[159] The investor will thus hold a portfolio comprising of low-risk stocks.[160] This will, however, have the effect of reducing the diversification of the portfolio.[161]

According to MPT, the best method of achieving the desired risk/return combination is not by holding a portfolio of low-risk stocks, but rather to mix risky assets with relatively risk-free assets.[162] In other words, securities with typically low betas, such as corporate or government bonds or other fixed-income investments, should be added to the portfolio to decrease the average beta of the portfolio to 0.5.[163]

5 3 Conclusion

Casting out riskier stocks to reduce portfolio risk or increasing the concentration in riskier stocks to gain higher expected returns sacrifices diversification. A professional investment manager who fails to diversify adequately, raises the risk of his client's portfolio above systematic risk,[164] and the market does not compensate the client with higher returns.[165] No reasonable investment manager would add risk to a portfolio if he could achieve the client's objectives with less risk. Stated differently, a reasonable investment manager would construct a non-diversified portfolio only if he

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157 Hagstrom *The Warren Buffet Portfolio* 22: "…no investor can achieve above-average gains without assuming above average risk".

158 Langbein & Posner (1976) *Am B Found Res J* 12.

159 13.

160 Halbach (1992) *Real Prop Prob & Tr J* 430.

161 Langbein & Posner (1976) *Am B Found Res J* 12

162 Halbach (1992) *Real Prop Prob & Tr J* 430.

163 Begleiter (1999) *Maine LR* 62; Langbein & Posner (1976) *Am B Found Res J* 12.

164 See para 3 3 above.

165 See para 3 2 above.

was certain that the strategy would produce an expected return equal to or above what he could achieve simply by raising systematic risk.[166]

6 The integral role of professional investment managers

Based on what has been discussed thus far, it may seem that the only rational strategy under MPT is to invest in a market index fund and borrow funds if a higher return is desired, or buy securities with low betas if less risk is required. This raises a crucial question: if the most efficient portfolio can be created by adopting a passive strategy, is there any need for expert assistance when investing in accordance with MPT? It is submitted that the answer to this question is yes. There are three reasons why investors require assistance from professional investment managers: first, different opinions exist regarding the extent of diversification required when investing according to MPT; second, there are professional skills involved in constructing a portfolio with different asset classes, monitoring its performance, and adjusting the asset allocation when circumstances change; and third, active management strategies might be necessary in certain situations. These reasons will now be considered.

6 1 Different opinions regarding the extent of diversification

According to Langbein and Posner, investing only in a market index fund, does not "exhaust the possibilities for diversification".[167] Begleiter states that:[168]

> "While the extent of diversification required is subject to dispute, the necessity of diversification is not".

Market index funds attempt to duplicate some market index,[169] for example, the S&P 500.[170] The S&P 500 is broad representation of the United States equity market, but it does not contain such other asset classes as small stocks, real estate,

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[166] Bines (1976) *Columbia LR* 753.

[167] Langbein & Posner (1976) *Am B Found Res J* 31.

[168] Begleiter (1999) *Maine LR* 35.

[169] See para 5 above.

[170] An example of a market index in South Africa is the JSE All Share Index (ALSI).

commodities, metals, and non-United States securities.[171] If MPT is taken to its logical conclusion, an investor should include some of each type of investment in his portfolio. Indeed, purists assert that an investor's portfolio should theoretically include the aggregate of all risky assets.[172] It may well be that investing in the full range of risky assets will be necessary since assets react differently to different events.[173] There are, for example, differences in performance of established companies and new enterprises, and these differences cannot be ignored.[174] This is why some academics believe that adding certain assets to a portfolio (or investing in other markets) will make the portfolio more diversified than a pure market index fund.

One of these academics, Halbach, suggests that investors should pursue an investment strategy that includes programmes involving real estate and venture capital.[175]

Another academic, Levy, suggests that precious metals, foreign stocks and futures contracts should be added to a portfolio to contribute to the quality of the portfolio's diversification. In his paper, Levy offers compelling evidence of the benefits of including these speculative, high-risk assets in a portfolio. He compared a market index fund that was 98.8% as diversified as the broad-based S&P 500 to what he called an "optimal portfolio". In his comparison, the expected returns of each of the three investments, namely an index of metals stocks, an index of foreign stocks, and an index of futures contracts, were 10.2% – the same as the market index fund. The optimal portfolio's resultant mix was 48% market index fund, 6% metals, 18% foreign stocks and 28% futures contracts. While the standard deviation of the market index fund was 15.3%, the standard deviation of the optimised portfolio turned out to be 11.9%. The result was nearly a 23% reduction in risk compared to the pure market index fund.[176]

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[171] Elton & Gruber "The lessons of modern portfolio theory" in Longstreth *Modern Investment Management* 174; Levy (1994) *Geo Mason U LR* 17.

[172] EC Halbach "Trust investment law in the Third Restatement" (1991) 77 *Iowa LR* 1151 1163.

[173] Begleiter (1999) *Maine LR* 35 footnote 85; Butler (1995) *Bond LR* 126-127.

[174] Elton & Gruber "The lessons of modern portfolio theory" in Longstreth *Modern Investment Management* 174.

[175] Halbach (1991) *Iowa LR* 1163.

[176] Levy (1994) *Geo Mason U LR* 23-25.

Another academic, Gordon, suggests that adding foreign securities and futures contracts, and using options, will increase the diversification of a portfolio.[177] According to Gordon, the returns from foreign companies respond to different economic factors than the returns from a country's own firms, while futures and options enable an investor to "reshape the risk associated with owning a particular security".[178]

6 2 Maintaining an appropriate mixture of asset classes

Under MPT, the role of a professional investment manager is to assist an investor in assembling a diversified portfolio with an appropriate level of systematic risk.[179] The appropriate level of risk depends on the investment objectives of the investor.[180] Determining the preferred risk automatically determines the expected return, and vice versa.[181]

Suppose the beta coefficient of a certain market index fund is 0.86 and its standard deviation is 15.3%. The investor might not be willing to bear a standard deviation of 15.3%. As discussed above, the investment manager can lower the beta of the investor's portfolio by adding asset classes with typically low betas.[182] Such asset allocation determinations usually involve a relatively long-term structuring of the portfolio.[183] However, the investor's investment objectives might change.[184] This will require the investment manager to adjust the portfolio's asset allocation to suit the investor's new objectives.

It should be pointed out that MPT does not allow for tactical portfolio manipulation. To be more specific, the theory does not support an approach where an investment manager makes strategic shifts among asset classes in an attempt to take

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[177] Gordon (1987) *N Y U LR* 52-53.

[178] 53 footnote 2 and 3. For a discussion of futures and options, see chapter 7 para 2 2 2.

[179] Sterk (2010) *Cornell LR* 859.

[180] Langbein & Posner (1976) *Am B Found Res J* 32.

[181] See para 5 2 above.

[182] See para 5 2 above.

[183] Halbach (1992) *Real Prop Prob & Tr J* 427 footnote 72.

[184] Maginn et al *Managing Investment Portfolios* 298.

advantage of market opportunities or in response to changes in the economic environment.[185]

Another challenge to portfolio construction is that the correlations among assets do not remain constant. The correlations among asset class returns change over time or in particular circumstances.[186] The investment manager will have to change the portfolio's mix of assets when correlations break down.[187]

Investors require assistance from professional investment managers since professional skills are required to construct a diversified portfolio with different asset classes, monitor its performance, and adjust the asset allocation when an investor's objectives change or the correlations between assets break down.

6 3 The need for active management

Active management strategies might be necessary in certain situations. Active investing is when a professional investment manager trades stocks under conventional stock-picking principles following research that suggests opportunities for outperforming the market.[188] Active investment requires high levels of competence and special skills.[189]

There are two situations where the use of active investing strategies might be appropriate: first, where the market in which an investor wants to operate does not approximate closely to the efficiency model;[190] and second, where an active investing strategy will make the equity component of the portfolio more diversified and thus less risky. The first situation is fairly easy to understand, and the major areas where the markets are less efficient are listed above.[191] The second situation requires explaining.

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[185] Langbein & Posner (1977) *Am B Found Res J* 20.

[186] Shipway (2009) *T & T* 70.

[187] Maginn et al *Managing Investment Portfolios* 695.

[188] Rizzi (1975) *Notre Dame Law* 526 footnote 63; Langbein & Posner (1977) *Am B Found Res J* 21.

[189] Ruce (2012) *South Texas LR* 670.

[190] Butler (1995) *Bond LR* 126-127.

[191] See para 3 4 above.

One of the characteristics of the South African stock market is that it is highly concentrated:[192]

> "Currently Naspers, the largest company in South Africa by market capitalisation, makes up over 20% of the SWIX [shareholder weighted] Top 40 Index: it would take the 16 biggest companies in the S&P 500 Index to make up the equivalent weighting of Naspers in that market … Prior to the rise of Naspers, it was the resources sector that dominated the local market, comprising nearly 50% of the SWIX Top 40 Index value at the top of the resources cycle."

One way of addressing the issue of high market concentration is by using "core-satellite investing". Financial intermediaries developed core-satellite investing in the United States in the 1970s.[193] In their 1977 article, Langbein and Posner refer to this approach as the "core/noncore concept";[194] these days, financial intermediaries refer to it as core-satellite investing.[195] Core-satellite investing involves investing in a core portfolio, typically a market index fund, as well as in actively managed separate portfolios.[196] The general principle that the investments in the portfolio should not be closely correlated, remains. Therefore, the style or stock selection of the satellite portfolios should be different from the core portfolio. An example of core-satellite investing in a South African context would be the following: [197]

> "A core portfolio that tracks a large-capitalisation index, such as the FTSE/JSE Top 40, could be complemented by satellite portfolios with exposure to managers that specialise in small capitalisation shares."

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[192] J Lambridis "Why active management beats passive in South Africa" (01-08-2017) *Prudential* <https://www.prudential.co.za/insights/articlesreleases/why-active-management-beats-passive-in-south-africa> (accessed 08-12-2017).

[193] Langbein & Posner (1977) *Am B Found Res J* 22-23.

[194] 22.

[195] Anonymous "Core-satellite investing – A powerful investment strategy" (01-02-2017) *Vanguard* <https://www.vanguard.co.uk/documents/adv/literature/client_material/core-satellite-investing-guide.pdf> (accessed 06-10-2017).

[196] Langbein & Posner (1977) *Am B Found Res J* 23.

[197] L Du Preez "The case for mixing active and passive funds" (25-05-2016) *Personal Finance* https://www.iol.co.za/personal-finance/the-case-for-mixing-active-and-passive-funds-2026095 (accessed 06-10-2017).

According to Langbein and Posner, the fact that core-satellite investing involves a major commitment to a passive investment strategy is a point in its favour.[198] Combining active and passive strategies requires expert assistance; the involvement of a professional investment manager is thus essential.

7 Conclusion

Technically speaking, MPT comprises Harry Markowitz's portfolio selection theory, which was first introduced in 1952, and William Sharpe's contributions to the theory of financial asset price formation, which was introduced in 1963 and came to be known as the CAPM. Markowitz admits that the diversification of investments has been a well-established practice long before he published his paper on portfolio selection in 1952. However, what was lacking prior to 1952 according to Markowitz was "an adequate theory of investment that covered the effects of diversification when risks are correlated, distinguished between efficient and inefficient portfolios, and analysed risk-return trade-offs on the portfolio as a whole".[199] MPT solved this problem because it deals with the effects of diversification when risks are correlated, distinguishes between efficient and inefficient portfolios, and creates a mathematical framework that allows investors to have some idea of the risk and return that they might expect from the combination when mixing individual investments.

There are a number of key lessons at the centre of MPT: first, MPT defines what constitutes return using the concept of total return; second, when managing an investment portfolio, the focus should be on the total portfolio and not on the individual investments; third, no asset or investment technique is inherently good or bad or prohibited *per se* as too risky; and fourth, diversification is essential to the management of risk. Chapters 4 to 6 will illustrate how these lessons have been incorporated into the trust law of the respective foreign jurisdictions.

There are three reasons why investors require expert assistance when investing in accordance with MPT: first, different opinions exist regarding the extent of diversification required when investing according to MPT; second, professional skills are required to construct a portfolio with different asset classes, monitor its

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[198] Langbein & Posner (1977) *Am B Found Res J* 23.

[199] Markowitz (1999) *FAJ* 5.

performance, and adjust the asset allocation when circumstances change; and third, active management strategies might be necessary in certain situations.

Butler summarises the advantage of MPT as follows:[200]

> "The advantage of the theory is that a careful application of its principles allows an investor to aim for reasonably good returns with a greater degree of security than was possible under previously popular models of investment behaviour."

The main reason why investors are capable of achieving a greater degree of security under MPT is due to the theory's emphasis on diversification or, to be more precise, its emphasis on the "right kind" or "proper" diversification. In order to reduce a portfolio's overall risk, MPT requires an investor to combine investments that do not go up and down in value at the same time. The chapter demonstrated that this type of diversification is highly effective in reducing risk without reducing expected return. It is submitted, therefore, that MPT presents a better account of risk and safety, and thus a better guide to prudent investment, than other models of investment behaviour.

Taking the above-mentioned into consideration, MPT emerges as a highly attractive investment decision tool for investors in general. It should be borne in mind that an individual investor is free to accept more risk than necessary in constructing his portfolio. A greater opportunity for high gain may, for example, excite the investor enough to outweigh the greater risk associated with his portfolio. Such an attitude, however, is not an appropriate course of action for a professional investment manager who, in most cases, is required to ensure an appropriate risk level in light of the needs of his client and is obliged to be risk averse. Risk aversion means that given two investment portfolios that offer the same level of return, the investor will choose the less risky one. The chapter illustrated that the risk of a diversified portfolio is lower than the risk of a non-diversified portfolio. Consequently, a risk averse investment manager would choose a diversified portfolio. In doing so, the investment manager is able to provide his client with good returns and a greater degree of security than is possible under other theories of investment. It is submitted, therefore, that an investment strategy based on MPT is the best possible approach for someone managing someone else's assets.

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[200] Butler (1995) *Bond LR* 119.

Chapters 4 to 6 will attempt to confirm this last statement by showing the benefits of using MPT strategies when investing and managing the assets of trust beneficiaries.

CHAPTER 4 – THE DEVELOPMENT OF TRUSTEES' INVESTMENT STANDARDS IN NEW YORK

1 Introduction

This chapter describes and analyses the development of trustees' investment standards in New York. An examination of the trust law in New York indicates that trustees are judged by a rule based on modern portfolio theory ("MPT") – the prudent *investor* rule.[1] Previously, the prudent *man* rule governed the way trustees invested.[2]

The purpose of this chapter is to provide answers to four important questions: first, what are the main characteristics of the prudent man rule? Second, why did the prudent man rule need modernisation? Third, what set the stage for the evolution from the prudent man rule to the prudent investor rule? Fourth, what changes were made to trustee investment standards and what are the core features of the prudent investor rule? In answering these questions, the chapter explains the problems that trustees face when they are unable to rely on a rule based on MPT, provides a better understanding of the benefits and features of the prudent investor rule, and illustrates which areas of trustee investment have to change in order for reform to occur.

Following this introduction, the chapter is divided into five sections, which are summarised in the conclusion at the end of the chapter. Section 2 briefly discusses the influence that England had on the development of trustee investment practices in nineteenth-century United States, as well as the differences that existed regarding trustee investing between these two countries. Following this discussion, the section details the historical evolution of trustee investment standards in the United States from 1830 to 1930. Section 3 describes what led to the majority of states adopting the prudent man rule after 1930. The section explains how the position in New York differed from other states and that it took another 40 years before New York's version of the prudent man rule was legislated. The remaining part of section 3 clarifies the main features of New York's prudent man rule and compares its features with the version of the prudent man rule that governed trustee investing in most other states. Section 4 discusses criticism by certain authors and academics of the

[1] To be specific, New York's version of the prudent investor rule: see para 5 1 below.

[2] To be specific, New York's version of the prudent man rule: see para 3 2 below.

prudent man rule that most states adopted from 1976 to 1987. Section 5 describes the prudent investor rule as formulated in New York's Prudent Investor Act. The section demonstrates the progression of trustees' investment standards by discussing the fundamental changes made by the Act, some of the key features of the new rule, and the effect of the new standard on trustee investing. Section 6 presents a major criticism of New York's prudent investor rule and considers whether the criticism of the rule is justified.

2 The early development of trustees' investment standards

2 1 A shortage of safe investments

England greatly influenced the development of trustee investment practices in nineteenth-century United States.[3] The English rules for trust fund investing were the product of financial disaster.[4] It is thus understandable that the rules were quite conservative.[5] The rules were largely designed to protect beneficiaries from losses caused by speculative investments.[6] The English Court of Chancery developed a list of presumptively proper investments for trustees.[7] Trustees were generally limited to investing in government securities, such as British consols,[8] and first mortgages.[9] England's influence resulted in the United States later adopting England's legal list.[10]

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[3] SP Johnson "Trustee investment: the prudent person rule or modern portfolio theory, you make the choice" (1993) 44 *Syracuse LR* 1175 1175.

[4] RH Borkus "A trust fiduciary's duty to implement capital preservation strategies using financial derivative techniques" (2001) 36 *Real Prop Prob & Tr J* 127 130. For a detailed discussion of the development of trust investment law in England, see chapter 5 para 2.

[5] LJ Bobo "Nontraditional investments of fiduciaries: re-examining the prudent investor rule" (1984) 33 *Emory LJ* 1067 1071.

[6] WB Phillips "Chasing down the devil: standards of prudent investment under the Restatement (Third) of Trusts" (1997) 54 *Wash & Lee LR* 335 337-338.

[7] MM Schanzenbach & RH Sitkoff "Did reform of prudent trust investment laws change trust portfolio allocation?" (2007) 50 *J L & Econ* 1 5.

[8] A British consol was a perpetual interest-bearing obligation first issued by the British government in 1751: Phillips (1997) *Wash & Lee LR* 338 footnote 19.

[9] MA Shattuck "The development of the prudent man rule for fiduciary investment in the United States in the Twentieth Century" (1951) 12 *Ohio St LJ* 491 492.

[10] PJ Ruce "The trustee and the prudent investor: the emerging acceptance of alternative investments as the new fiduciary standard" (2012) 53 *South Texas LR* 653 655.

The conditions in the early United States, however, were both economically and politically quite different from those in England.[11] The United States did not have a developed financial market or a stable government capable of issuing and backing government securities of an equivalent rating to British consols.[12] This led to a shortage of "safe" trustee investments that were regularly available in England.[13] This shortage encouraged the majority of American trustees to direct their investments toward promising industrial enterprises instead.[14] As a result, it became necessary for American courts to deliberate whether trustees could take part in a more extensive range of trust investments.

2 2 The traditional prudent man rule

In *Harvard College v Amory*[15] ("*Amory"*), the Supreme Judicial Court of Massachusetts rejected the conservative English approach requiring investment in government securities only.[16] The material facts of the case were as follows: the testator bequeathed $50 000 in trust for the maintenance of his wife during her life.[17] Upon his wife's death, the remainder of the trust was to be divided equally between Harvard College and the Massachusetts General Hospital.[18] The trustees were directed to invest the $50 000 in safe and productive stocks. It was clear that the testator did not intend to limit the investments simply to interest-bearing bonds.[19] The trustees purchased shares in manufacturing and insurance company stocks. These

[11] RD Blair & AA Heggestad "The prudent man rule and preservation of trust principle" (1978) 1 *L F* 79 85.

[12] Borkus (2001) *Real Prop Prob & Tr J* 130-131; Johnson (1993) *Syracuse LR* 1175.

[13] Shattuck (1951) *Ohio St LJ* 493.

[14] Phillips (1997) *Wash & Lee LR* 338.

[15] 26 Mass. (9 Pick.) 446 (1830).

[16] JN Gordon "The puzzling persistence of the constrained prudent man rule" (1987) 62 *N Y U LR* 52 57.

[17] D Grosh "Trustee investment: English law and the American prudent man rule" (1974) 23 *Int'l & Comp LQ* 748 754.

[18] LD Laurino "Investment responsibility of professional trustees" (1977) 51 *St John's LR* 717 718 footnote 8.

[19] Ruce (2012) *South Texas LR* 661.

shares subsequently fell in value.[20] The college and the hospital brought suit alleging that the trustees acted imprudently by investing in corporate stocks.[21]

The court pointed out that it was not appropriate merely to dismiss investments in stocks as safe or unsafe.[22] The court recognised that property management in the United States has always been necessarily speculative.[23] Furthermore, the court also realised that no investment in the United States was universally "safe". As Putnam J said, "Do what you will, the capital is at a hazard".[24] For example, investments in public debt were not completely "safe":[25]

> "If the public funds are resorted to, what becomes of the capital when the credit of the government shall be so much impaired as it was at the close of the last war?"

Based upon the understanding that the trust fund is always subject to some risk regardless of the investment choices of the trustees, the court upheld the trustees' investment.[26] Putnam J expressed the new rule as follows:[27]

> "All that can be required of a trustee, is that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

The rule formulated in *Amory* can be referred to as the "Massachusetts prudent man rule",[28] the "common law prudent man rule",[29] the "American version of the prudent man standard",[30] the "flexible prudent man rule",[31] the "original prudent man

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[20] Phillips (1997) *Wash & Lee LR* 339 footnote 26.
[21] Laurino (1977) *St John's LR* 718.
[22] Ruce (2012) *South Texas LR* 661.
[23] Bobo (1984) *Emory LJ* 1072.
[24] *Harvard College v Amory* 26 Mass. (9 Pick.) 446 (1830) 461.
[25] 461.
[26] Grosh (1974) 23 *Int'l & Comp LQ* 754.
[27] *Harvard College v Amory* 26 Mass. (9 Pick.) 446 (1830) 461.
[28] DM Tralins "Contemporary fiduciary investments: why Maryland needs the prudent man rule" (1983) 12 *U Baltimore LR* 207 212.
[29] Bobo (1984) *Emory LJ* 1070.
[30] Borkus (2001) *Real Prop Prob & Tr J* 131.

rule”,[32] or the “prudent man rule” as traditionally understood.[33] Hereafter it is referred to as the “traditional prudent man rule”.

There are three important observations to be made here regarding the traditional prudent man rule: first, in making investment decisions, trustees were subject to the prevailing standard of how prudent men handled their *own* affairs, and not how prudent men safeguarded the property of *others*.[34] Second, the rule did not draw distinctions between categories of “proper” and “improper” investments,[35] but relied on the skill and care of the trustees to protect the trust investments. Grosh observes that:[36]

> “This [Putnam’s statement] is very broad language and its thrust is clearly that it is not the type of investment which is important (provided it is one that pays income), but rather the reasonableness of the investment in light of all relevant factors, and the exercise of care in making the investment.”

Third, the rule directed trustees not to speculate.[37] Trustees were thus not allowed to enter into transactions for a quick turnover or profit.[38] It is worth pointing out that it was “speculation” that was prohibited, and not investing in “speculative investments”. Trustees could invest in speculative investments in certain circumstances:[39]

> “…a trustee only needed to exercise good judgment and the care of a prudent man in order for the courts to interpret even speculative investments such as common stocks as prudent.”

2 3 Narrowing of the traditional prudent man rule

Initially, the investment rule in New York was stated in terms not much different from those promulgated in *Amory*. However, over time, the rule began to be

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[31] JV Rizzi “Trustees investment powers: imprudent application of the prudent man rule” (1975) 50 *Notre Dame Law* 519 523.

[32] Schwartzel (2002) *Baylor LR* 703.

[33] G Moffat *Trust Law Text and Materials* 5 ed (2009) 480.

[34] *Harvard College v Amory* 26 Mass. (9 Pick.) 446 (1830) 461.

[35] Rizzi (1975) *Notre Dame Law* 520.

[36] Grosh (1974) 23 *Int’l & Comp LQ* 757.

[37] 761.

[38] Shattuck (1951) *Ohio St LJ* 517.

[39] Borkus (2001) *Real Prop Prob & Tr J* 131.

narrowed in practice in important respects.[40] Nearly forty years after *Amory*, the rule was re-examined by the New York State Court of Appeals in *King v Talbot*[41] ("*Talbot*").

In *Talbot*, the testator died in 1845 and left to each of his three minor children a sum of $15 000 in trust. At first, the trustees invested the funds in United States treasury notes and state bonds, but eventually sold these investments and took the profits and purchased stocks in various corporations. The investments underperformed, and the beneficiaries sued the trustees.[42] The court ruled investments in equities to be improper for responsible trust administration.[43] From this conclusion, the court held that the beneficiaries had the right to reject the stock investments.[44] In rendering its decision, the court explained that a trustee was bound to:[45]

> "…employ such diligence and such prudence in the care and management, as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs."

The court then listed the types of investments excluded by the standard adopted in *Talbot*:[46]

> "This necessarily excludes all speculation, all investments for an uncertain and doubtful rise in the market, and, of course, everything that does not take into view the nature and object of the trust, and the consequences of a mistake in the selection of the investment to be made."

The court's ruling as a whole reflected the feeling that trustees should only invest in secure investments.[47] The court's stance of preferring secure investments was prompted by three factors: first, the court held that "the preservation of the fund, and the procurement of a just income therefrom, are primary objects of the creation of the

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[40] Shattuck (1951) *Ohio St LJ* 495.

[41] 40 N.Y. 76 (1869).

[42] Ruce (2012) *South Texas LR* 660; LM Friedman "The dynastic trust" (1964) 73 *Yale LJ* 547 556.

[43] Phillips (1997) *Wash & Lee LR* 340 footnote 34.

[44] *King v Talbot* 40 N.Y. 76 (1869) 89-90.

[45] 85-86.

[46] 86.

[47] Ruce (2012) *South Texas LR* 660.

trust itself, and are to be primarily regarded".[48] Second, the court implied that there were two kinds of prudence – one for businessmen generally, and one for managers of trust funds:[49]

> "If it be said, that men of the highest prudence do, in fact, invest their funds in such stocks, becoming subscribers and contributors thereto, in the very formation thereof, and before the business is developed, and in the exercise of their judgment, on the probability of its safety and productiveness, the answer is, so do just such men, looking to the hope of profitable returns, invest money in trade, and adventures of various kinds. In their private affairs, they do, and they lawfully may, put their principal funds at hazard; in the affairs of a trust they may not. The very nature of their relation to it forbids it."

Third, the court viewed investments in stocks as dangerous because it removes the trust assets from the control and discretion of the trustees. The court reasoned as follows:[50]

> "The moment the fund is invested in bank, or insurance, or railroad stock, it has left the control of the trustees; its safety and the hazard, or risk of loss, is no longer dependent upon their skill, care, or discretion …"

In addition to these three factors, the economic factors at the time also seem to have influenced the court in adopting its stance. First, government bonds were available in greater quantities by 1869 than in 1830 when *Amory* was decided. Woodruff J had little doubt that government bonds would retain their value and continue to be a safe means of trust investment.[51] Second, the American Civil War, fought in the United States from 1861 to 1865, caused the destruction of many private companies, which encouraged the view that purchasing shares in a company was not safe.[52]

In summary, *Talbot* dramatically narrowed the traditional prudent man rule.[53] Trustees had to place a greater emphasis on safety in selecting investments. The

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[48] *King v Talbot* 40 N.Y. 76 (1869) 86.

[49] 89.

[50] 88.

[51] Laurino (1977) *St John's LR* 719 footnote 15.

[52] Phillips (1997) *Wash & Lee LR* 340-341; Ontario Law Reform Commission *Report on the Law of Trusts* (1984) Volume 1 207.

[53] Shattuck (1951) *Ohio St LJ* 495.

court in effect restricted trustees' choice of investments to government bonds and mortgages,[54] and forbade investment in corporate stocks.[55]

2 4 Legal lists

The decision in *Talbot*, setting forth court-sanctioned investments, subsequently led to the passage of a New York statute in 1889 governing permissible trust investments.[56] This marked the beginning of so-called "legal lists". Legal lists were essentially "lists of investments that a legislature has deemed prudent".[57] Designed to protect trust beneficiaries from inexperienced or ignorant trustees,[58] the legal lists contained mainly government bonds[59] and mortgages.[60]

By 1900, only a handful of states continued to follow the traditional prudent man rule.[61] Thus, only a few states permitted trustee investment in common stocks.[62] Settlors who wanted their trustees to invest in stocks or other types of property had to provide so in their trust instruments.[63] The restrictive New York position soon became dominant among the states. For example, Ohio, Pennsylvania, Texas, Illinois, California and all Northwest territory jurisdictions developed legal lists that specified which classes of investments were eligible for trust portfolios.[64]

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[54] PG Haskell "The prudent person rule for trustee investment and modern portfolio theory" (1990) 69 *North Carolina LR* 87 89; Tralins (1983) *U Baltimore LR* 211.

[55] Langbein (1996) *Iowa LR* 643 footnote 24.

[56] Tralins (1983) *U Baltimore LR* 211-212.

[57] Johnson (1993) *Syracuse LR* 1176.

[58] Tralins (1983) *U Baltimore LR* 212.

[59] Blair & Heggestad (1978) *Law Forum* 86.

[60] A Fleming "Prudent investments: the varying standards of prudence" (1977) 12 *Real Prop Prob & Tr J* 243 224.

[61] Blair & Heggestad (1978) *Law Forum* 86. It should be pointed out that there is no "American law of trusts". Instead, the law of trusts is governed by each separate state as a matter of property law: Ruce (2012) *South Texas LR* 677; New Zealand Law Commission *Review of the Law of Trusts – Introductory Issues Paper* (2010) Issues Paper 19 47; BR Hauser "United States" in A Kaplan, BR Hauser & P Ogden (eds) *Trusts in Prime Jurisdictions* 2 ed (2006) 315 319.

[62] Haskell (1990) *North Carolina LR* 90.

[63] Fleming (1977) *Real Prop Prob & Tr J* 244.

[64] Shattuck (1951) *Ohio St LJ* 499.

3 Scott's prudent man rule

3 1 The restrictive nature of legal lists

By 1930, most states followed the legal list approach.[65] However, two factors became operative, which focused attention upon the restrictive nature of the legal list approach and led to its decline: first, the stock market crash of 1929 showed that many of the apparently "safe investments" did not offer adequate protection to beneficiaries' capital.[66] The markets collapsed in October 1929 and the United States descended into the Great Depression.[67] Equities were the first to be affected by the depression.[68] For example, *In re Chamberlain's Estate*[69] ("*Chamberlain's Estate*") involved an estate settlement in which the testator died immediately before the great market collapse. The bulk of the assets in the estate were stocks listed on the New York Stock Exchange. Between the death of the testator and the date of the court hearing, the estate reduced from $258 000 to less than $200 000.[70] Bond values held up fairly well during this initial period.[71] But eventually, and without much delay, all types of investments were grievously affected. For example, "guaranteed" mortgage bonds stood in default and railroad bonds declined with disheartening rapidity.[72]

Second, after 1933, states that operated under the prudent man concept (in one form or another) provided beneficiaries with a greater return on investments. With the emergence of a new financial scene, the investment options in these states were much wider, which created an opportunity to maintain a much higher yield on trust portfolios.[73] For example, the yield on portfolios limited to legal list investments did not exceed 2% on average, while it was comparatively easy to maintain a 4% yield in the states that followed a prudent man standard.[74]

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[65] 499.

[66] Ontario Law Reform Commission *Report on the Law of Trusts* 207.

[67] Ruce (2012) *South Texas LR* 663; Shattuck (1951) *Ohio St LJ* 496.

[68] Grosh (1974) 23 *Int'l & Comp L Q* 756.

[69] 156 A. 42 (N.J. Prerog. Ct. 1931).

[70] Ruce (2012) *South Texas LR* 663.

[71] Grosh (1974) 23 *Int'l & Comp LQ* 756.

[72] Shattuck (1951) *Ohio St LJ* 496-497.

[73] Bobo (1984) *Emory LJ* 1074.

[74] Tralins (1983) *U Baltimore LR* 213; Grosh (1974) 23 *Int'l & Comp LQ* 756.

The combined effect of these two factors led to a movement to abandon the legal list approach and to replace it with a broader, more flexible standard. The pressure in the legal list states mounted, not for wider lists, but for trustees to have the right to choose "the best investments for their particular trust".[75] Out of the movement came the Model Investment Statute developed by the Trust Division of the American Bankers Association. From 1940, the statute was adopted (with minor variations) over the next two decades in the majority of the states. The statute picked up the key phrases in *Amory* and thus reflected the traditional prudent man rule. However, the standard was too general and did not provide trustees with the necessary guidelines:[76]

> "The certainty of the old 'legal list' had been replaced by an amorphous standard which read well on first impression and seemed to sanction flexibility and selection according to concepts current at the time of investment but which, in fact, created problems because the standard was so very general and devoid of specific guidance to the trustee."

Consequently, the courts turned to Scott's work for guidance. Scott is the reporter of the first Restatement of Trusts ("Restatement (First)"), published in 1935, and the second Restatement of Trusts ("Restatement (Second)"), published in 1959.[77] The relevant sections on trustee investing in these two restatements are virtually identical. He is also the author of the leading treatise on trusts, namely *The Law of Trusts*, first published in 1939 (first edition), and revised and updated in 1956 (second edition), and 1967 (third edition). The third edition was updated with pocket parts until his death in 1981. The publisher has continued the updates.[78] Hereafter, the first three editions of Scott's Treatise on trusts is referred to as "Scott's Treatise".

Scott's work has played a pivotal role in the legal understanding of trustees' investment functions. In this area, most cases and commentaries cited either Scott's

[75] Ontario Law Reform Commission *Report on the Law of Trusts* 208.

[76] Fleming (1977) *Real Prop Prob & Tr J* 245.

[77] Gordon (1987) *N Y U LR* 58. Restatements are issued by the American Law Institute. They are not binding and do not carry any actual authority, though they are persuasive in that they are an interpretation of the trends established by the courts: Ruce (2012) *South Texas LR* 677. The American Law Institute has issued many restatements; in the area of trust law, three restatements have been completed. The most recent restatement, the Restatement (Third) of Trusts, is discussed below in para 4 5 1.

[78] Gordon (1987) *N Y U LR* 58 footnote 17.

Treatise or the Restatements of Trusts as authoritative sources, or relied on formulations derived from these two sources.[79] Therefore, from 1940 to 1992[80] what was ordinarily understood as the "prudent man rule",[81] was in fact the traditional prudent man rule as influenced by the work of Scott.[82] This version of the prudent man rule is hereafter referred to as "Scott's prudent man rule".

3 2 The position in New York

Despite the majority of the states adopting Scott's prudent man rule, New York's 1889 statute (with various amendments) continued in effect in New York until 1950.[83] Responding to pressures from the New York State Bankers Association,[84] the first break from the legal list approach came with a statute permitting investment up to 50% of the total market value of the trust fund in corporate stocks.[85] Tralins states that this was a significant change for New York, the leading legal list jurisdiction.[86] However, relatively few equities were eligible under the new statute since they had to meet stringent fixed requirements such as high ratings by investment services, and excellent earnings and dividend records.[87] The final break from the rigid legal list approach came in 1970.[88] New York legislated New York's version of the prudent man rule. The rule is hereafter referred to as New York's prudent man rule.

3 3 The main features of New York's prudent man rule

This section discusses the main features of New York's prudent man rule and compares it with the corresponding features of Scott's prudent man rule.

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[79] Fleming (1977) *Real Prop Prob & Tr J* 246; Schwartzel (2002) *Baylor LR* 714.

[80] The date that the Restatement (Third) was promulgated: JH Langbein "Reversing the nondelegation rule of trust-investment law" (1994) 59 *Missouri LR* 105 105.

[81] From 1970, sometimes also referred to as the "prudent *person* rule": CR Radigan "Advisory Committee: Prudent Investor Act" (05-09-2010) *Ruskin Moscou Faltischek* <http://www.rmfpc.com/advisory-committee-prudent-investor-act/> (accessed 04-11-2016) 2.

[82] Longstreth *Modern Investment Management* 39.

[83] Fleming (1977) *Real Prop Prob & Tr J* 244 footnote 8.

[84] Tralins (1983) *U Baltimore LR* 213.

[85] Laurino (1977) *St John's LR* 721-722.

[86] Tralins (1983) *U Baltimore LR* 213.

[87] 214 footnote 55; Shattuck (1951) *Ohio St LJ* 503-504.

[88] Laurino (1977) *St John's LR* 722.

3 3 1 No duty to protect against inflation

In 1970, no authority existed to suggest that trustees had to invest to protect trust capital from erosion by inflation. In fact, *Matter of Kilmer*[89] ("*Kilmer*") signalled quite the opposite by denying the existence of a general duty to invest with an eye to inflation.

In *Kilmer*, the capital beneficiaries of a testamentary trust claimed that the trustees had a duty to invest in common stocks to preserve the value of the capital of the trust.[90] The surrogate held for the trustees for two reasons:[91] first, the words of the will that established the trust showed that the testator's main concern was the welfare of his widow, the income beneficiary. This justified a course of investment that favoured her.[92] Second, the surrogate denied the existence of a general duty to invest to protect against inflation.[93]

Scott's Restatement (Second) recognised that inflationary concerns were a proper consideration when making investment decisions. The "likelihood of inflation" was listed in the comments to section 227 of the Restatement (Second) as the last of ten factors that trustees should consider in selecting investments.[94] However, recognising that inflationary concerns are a proper consideration when making investment decisions is very different from imposing a duty to invest in a manner that compensates for inflation.[95]

3 3 2 No speculative investments

In making investments, trustees were not authorised to make or retain trust investments that were speculative, even where the investments were "of such promise and character that a prudent person might make them for himself".[96] The

[89] 18 Misc.2d 60 (1959).

[90] *Matter of Kilmer* 18 Misc.2d 60 (1959) 67-68.

[91] In New York, the Surrogate's Court has jurisdiction over all actions and proceedings related to the affairs of decedents, probate of wills and administration of estates: Phillips (1997) *Wash & Lee LR* 372-373.

[92] *Matter of Kilmer* 18 Misc.2d 60 (1959) 68-69.

[93] KL Hirsch "Inflation and the law of trusts" (1983) 18 *Real Prop Prob & Tr J* 601 629.

[94] Laurino (1977) *St John's LR* 723 footnote 35.

[95] Haskell (1990) *North Carolina LR* 93.

[96] Laurino (1977) *St John's LR* 724.

antecedents of the rule can be traced to *Talbot*, in which the New York State Court of Appeals stated:[97]

> "[T]he trustee is bound to employ such diligence and such prudence in the care and management as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs. This necessarily excludes all speculation, all investments for an uncertain and doubtful rise in the market, and, of course, everything that does not take into view the nature and object of the trust, and the consequences of a mistake in the selection of the investment to be made."

Speculative investments were also forbidden under the Restatement (Second).[98]

3 3 3 The isolation approach

New York's prudent man rule required trustees to evaluate prudence one investment at a time. The Restatement (Second) also required that the prudence of each investment is assessed without regard to the context of the whole portfolio.[99]

This requirement can be referred to as the "individual asset rule",[100] the "item-by-item approach",[101] or the "isolation approach".[102] The rule is hereafter referred to as the isolation approach. Opposite to the isolation approach is the "total portfolio approach".[103] This approach determines the prudence of trustees' performance by analysing the performance of the total portfolio rather than by considering each individual investment in a portfolio separately.[104]

The isolation approach derives from *In re Bank of New York (Spitzer)*[105] ("*Spitzer*").[106] In *Spitzer*, a guardian *ad litem* was appointed to represent the

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[97] *King v Talbot* 40 N.Y. 76 (1869) 85-86.

[98] Johnson (1993) *Syracuse LR* 1179.

[99] Haskell (1990) *North Carolina LR* 93.

[100] MD Begleiter "Does the prudent investor need the Uniform Prudent Investor Act – an empirical study of trust investment practices" (1999) 51 *Maine LR* 27 71.

[101] Hirsch (1983) *Real Prop Prob & Tr J* 622.

[102] See Moffat *Trust Law* 482.

[103] Gordon (1987) *N Y U LR* 97.

[104] Laurino (1977) *St John's LR* 725.

[105] 35 N.Y.2d 512 (1974).

[106] Fleming (1977) *Real Prop Prob & Tr J* 248.

beneficiaries of a bank's common trust fund.[107] The guardian challenged the prudence of four of the bank's investment decisions.[108] Although the entire fund recorded a gross gain of $1 700 000, there were losses amounting to $238 000. The Surrogate's Court held for the bank on two of the four investments. Both sides appealed. The Appellate Division held for the bank on all four investments on the basis that the nett gain to the trust precluded any need for objections.[109] The New York State Court of Appeals affirmed the determination of the Appellate Division[110] but rejected the basis for the Appellate Division's ruling. Referring to *Talbot* and Scott's Treatise as authority, the court stated:[111]

> "The fact that this portfolio showed substantial overall increase in total value during the accounting period does not insulate the trustee from responsibility for imprudence with respect to individual investments for which it would otherwise be surcharged."

The Court of Appeals explained that nett increases should not insulate trustees from being held accountable for all of their investment decisions; the reasoning being that if trustees had this kind of immunity in rising markets, it might encourage unwarranted risk-taking in an effort to recover other losses.[112] The Court of Appeals held that with respect to each investment the trustee acted prudently.[113]

Academics interpreted the *dictum* of *Spitzer* to determine that each individual investment in a trust portfolio must be justified independently. In their 1976 article, Langbein and Posner state:[114]

> "The courts characteristically apply the prudent-man standard to each investment decision of the trustee rather than to the trust portfolio as a whole."

Fleming in his 1977 article states:[115]

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[107] JH Langbein & RA Posner "Market funds and trust-investment law" (1976) 1 *Am B Found Res J* 1 24 footnote 67.

[108] Johnson (1993) *Syracuse LR* 1178 footnote 29.

[109] Phillips (1997) *Wash & Lee LR* 372-373.

[110] *In re Bank of New York (Spitzer)* 35 N.Y.2d 512 (1974) 519.

[111] 517.

[112] 517.

[113] 518-519.

[114] Langbein & Posner (1976) *Am B Found Res J* 24.

[115] Fleming (1977) *Real Prop Prob & Tr J* 248.

"As recently as 1974, the New York Court of Appeals in *Matter of Bank of New York* (*Spitzer*), affirmed, again, the rule of individual, rather than total, performance."

Laurino writing in 1977 and referring to *Spitzer* and a 1949 case as authority states:[116]

"New York courts, to a large extent, have determined the prudence of a trustee's performance by examining each investment in question rather than by considering the performance of the fund portfolio as an entirety."

Bobo writing in 1984 and referring to Spitzer as authority states:[117]

"At common law, the fiduciary was required to defend the performance of each individual investment in the portfolio."

In contrast to the interpretation of these academics, a 1997 New York State Court of Appeals case, *Matter of Janes*[118] ("*Janes*"), found that New York common law was entirely consistent with the total portfolio approach. The position was stated to be as follows:[119]

"…the various factors affecting the prudence of any particular investment must be considered in the light of the 'circumstances of the trust itself rather than merely the integrity of the particular investment'."

Notwithstanding the finding in *Janes*, it is submitted that the correct interpretation of the *dictum* of *Spitzer* indeed correlates with that of the four academics above. The academics wrote their findings shortly after the case was decided, whereas the judges in *Janes* wrote their judgment 23 years after *Spitzer*. In addition, as discussed in paragraph 6 5 below, the judges in *Janes* were influenced by the Restatement (Third) of Trusts ("Restatement (Third)") and the New York Prudent Investor Act that was promulgated in 1994.

[116] Laurino (1977) *St John's LR* 725.

[117] Bobo (1984) *Emory LJ* 1078.

[118] 90 N.Y.2d 41 (1997).

[119] *Matter of Janes* 90 N.Y.2d 41 (1997) 51-52.

3 3 4 *No duty to diversify*

In the 1970s, it was a well-established rule in New York trust law that there was no absolute duty to diversify.[120] In other words, prudence did not require diversification.[121] This was known as "the optional diversification principle".[122]

In contrast, the Restatement (Second) required diversification;[123] albeit a very specific form of diversification. Trustees were required to evaluate the prudence of each investment separately in a diversified portfolio.[124] Thus, trustees could only diversify among non-speculative investments[125] because none other was permitted.[126] This approach to diversification had two implications for the way trustees invested: first, trustees could not make use of passive investment strategies.[127] For example, investing in a market index fund was prohibited because it exposed beneficiaries to the potentially speculative aspects of some of the stocks within the fund.[128] Second, the Restatement (Second) encouraged investments in low-risk, low-return securities that were strongly positively correlated, and therefore, according to Blair, achieved little risk reduction regardless of portfolio diversification.[129]

3 3 5 *Delegating investment functions not allowed*

The delegation of trustees' investment functions was prohibited under New York's prudent man rule, unless the governing instrument expressly authorised it.[130]

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[120] Laurino (1977) *St John's LR* 724-725.

[121] Gordon (1987) *N Y U LR* 98.

[122] 97.

[123] 97-98.

[124] SE Sterk "Rethinking trust law reform: how prudent is modern prudent investor doctrine" (2010) 95 *Cornell LR* 851 864.

[125] Levy (1994) *George Mason U LR* 8.

[126] Haskell (1990) *North Carolina LR* 94.

[127] A passive investment strategy requires minimal input from the investor, relies on diversification, and buys many stocks in the same market to match the performance of a market index: see chapter 3 para 5.

[128] Levy (1994) *George Mason U LR* 8. A market index fund is an index fund that is constructed to approximate the performance of a market index: see chapter 3 para 5.

[129] Blair & Heggestad (1978) *Law Forum* 91.

[130] CR Radigan, JF Hillman & PK Kelly "Does New York need a trust code?" (2011) 244 *N Y LJ* 1 1.

Trustees were allowed to obtain investment advice from professionals, but the trustees themselves had to make investment decisions.[131]

This was also the view adopted in the Restatement (Second). Section 171 of the Restatement placed trustees under a duty to beneficiaries not to "delegate to others the doing of acts which the trustee can reasonably be required personally to perform".[132] Courts widely interpreted section 171 to mean that trustees had to personally perform any duty that required the exercise of discretion, including the power to select investments.[133]

4 Criticism of Scott's prudent man rule

The findings in economic and financial theory detailed in chapter 3 of the research developed independently of Scott's prudent man rule. Trustees did not appear to be influenced by these findings.[134] However, from 1976 to 1987, a group of authors and academics began to draw attention to the relevancy of MPT to trust investment practices and called for reform in trustee investing. The criticisms of these authors and academics are discussed in the paragraphs that follow.

4 1 John Langbein and Richard Posner

4 1 1 Introduction

In 1976, two law professors, John Langbein and Richard Posner, then at the University of Chicago,[135] published an article that brought the learning of economic and financial theorists to the attention of practicing attorneys and legal academics.[136] Langbein and Posner embraced the lessons of MPT and wanted to integrate those lessons into trust law.[137] Begleiter gives Langbein and Posner the credit for beginning the integration of economic and financial theory into the law of trust

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131 Laurino (1977) *St John's LR* 724.

132 Langbein & Posner (1976) *Am B Found Res J* 19.

133 SM Dickson "Trust administration in Georgia and the prudent investor rule: may trustees delegate their investment powers?" (1998) 14 *Georgia St U LR* 633 648.

134 Begleiter (1999) *Maine LR* 38.

135 Langbein & Posner (1976) *Am B Found Res J* 1.

136 Begleiter (1999) *Maine LR* 39.

137 Sterk (2010) *Cornell LR* 861.

investments.[138] Their article contains two significant observations with respect to the legal standards that governed trustee investing: first, regarding the isolation approach and, second, regarding the delegation of investment decision-making.

4 1 2 The isolation approach

Langbein and Posner wanted to answer the question whether trustees could invest in a market index fund without thereby violating the legal standards that governed trustee investing.[139] Suppose that the investment strategy of the trustees of a particular trust is to hold a market index fund. The isolation approach determines that the trustees must evaluate the merits of the individual securities in the fund.[140] Should the trustees find securities that are speculative, they must exclude them from the fund.[141] However, such weeding out of speculative components of a market index fund is inconsistent with the fundamental premises of the market-fund approach.[142] Langbein and Posner suggest that the trustees should be able to invest in the market index funds without having to inquire into the prudence of the individual securities constituting the fund. The only condition being that the risk/return characteristics of the market index fund are at least as attractive as those of an individual security that would be considered a prudent investment for the trustees.[143]

From their discussion of market index funds, it is clear that Langbein and Posner endorse the total portfolio approach rather than the isolation approach. Further proof of their preference for the total portfolio approach is found in their discussion of the design of a trust portfolio. While discussing how to combine specific assets to form a trust portfolio, they state that the emphasis must be on the overall portfolio rather than the individual investments comprising the portfolio:[144]

> "… from the beneficiary's standpoint – which is, of course, the relevant standpoint – what counts is the performance of the portfolio rather than the performance of its individual components. If the value of the portfolio rises from $500 000 to $600 000, what does it

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[138] Begleiter (1999) *Maine LR* 39.

[139] Langbein & Posner (1976) *Am B Found Res J* 2.

[140] 26.

[141] 27.

[142] See chapter 3 para 5 2.

[143] Langbein & Posner (1976) *Am B Found Res J* 26.

[144] 6.

matter to the beneficiary whether this increase resulted from a uniform 20 percent increase in the value of all of the assets in the portfolio or from larger gains in a few of the assets partially offset by losses in others? Conversely, if the portfolio has declined in value, it is of small comfort to the beneficiary to know that one of the components did spectacularly well rather than that all had declined. From the beneficiary's standpoint, the portfolio *is* the relevant security."

4 1 3 Delegation of investment decision-making

Langbein and Posner illustrate that when trustees invest in mutual funds,[145] they are in actual fact violating the duty of non-delegation. By investing in mutual funds, trustees are delegating the selection of the individual securities that constitute the portfolio of the mutual fund to the mutual fund's manager. The manager then engages in conventional stock picking.[146]

Under Scott's prudent man rule, trustees were not allowed to delegate investment decision-making. In response to the issue of trustees possibly being held to have violated the non-delegation rule, two solutions arose in practice: first, nearly half of the states passed legislation authorising trustees to invest in mutual funds; and second, settlors, testators and their attorneys included clauses authorising such investments into standard-form trust instruments.[147]

Langbein and Posner offer a simpler solution. Their solution is that trustees should invest in a market index fund.[148] The manager of such a fund buys or sells securities according to a predetermined plan and does not exercise discretion by evaluating specific securities in order to decide whether to buy or sell them.[149] Accordingly, there is actually less delegation of a decision-making function by the trustees than in the case where they purchase shares in a conventional mutual fund. In effect, the manager of the market index fund simply executes the trustees' decision to hold a market portfolio.[150]

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[145] Mutual funds are known in South Africa as collective investment schemes or unit trusts: see chapter 2 para 2 2 10.

[146] Langbein & Posner (1976) *Am B Found Res J* 23.

[147] 22.

[148] 23

[149] See chapter 3 para 5.

[150] Langbein & Posner (1976) *Am B Found Res J* 23.

In summary, the duty of non-delegation discouraged trustees from investing in mutual funds that invested in shares. Three possible solutions have been identified: passing legislation authorising investment in mutual funds; authorising such investments in trust instruments; or investing in market index funds instead of conventional mutual funds. Another solution, discussed in paragraph 6 3 below, is to change the law regarding the delegation of trustees' functions in its entirety.

4 2 Austin Fleming

4 2 1 Introduction

At about the same time as Langbein and Posner's article, Austin Fleming, an attorney with a major bank, gave a presentation to a meeting of the largest organisation of trust and estate attorneys in the United States.[151] Fleming later published an article based on his remarks at the meeting.[152]

4 2 2 A return to the traditional prudent man rule

Fleming believes that the traditional prudent man rule was constrained by Scott's Treatise and the Restatement (Second).[153] In order to restore the rules regarding trustee investment standards, he advocates a return to the traditional prudent man rule:[154]

> "The language of Justice Putnam in *Harvard College [Amory]* that all that can be expected of a trustee is that he 'conduct himself faithfully and exercise a sound discretion', without being either a guarantor or a magician, comes hauntingly to mind and with it a hope that sensible courts in the land will yet harken to it and restore to a bewildered and frightened industry a rule of reason for trust investment action …"

Fleming criticises Scott's work as being primarily responsible for alterations to the traditional rule. For instance, Scott stated that the standard which a trustee must observe is not that which he would use in dealing with his own property, but that of

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[151] Begleiter (1999) *Maine LR* 39.

[152] Fleming (1977) *Real Prop Prob & Tr J* 243.

[153] 245. For a detailed discussion on the constraint of the traditional rule, see the discussion of Jeffrey Gordon: para 4 4 below. Gordon expands on Fleming's criticism of Scott.

[154] 255.

one who is a trustee of another's property. This change in emphasis led courts to emphasise conservation, rule that the primary duty was to safeguard the trust fund, and distinguish between speculation and investment.[155]

Furthermore, Fleming views the standard of prudence reflected in Scott's work as static. Static means that the standard was not capable of adapting to "changing times"[156] (eg rising inflation)[157] and "changing notions of investment opportunity and risk-taking"[158] (eg the findings of MPT).[159] "Changing times" and "changing notions of investment opportunity and risk taking" are examples of general circumstances. (General circumstances should be distinguished from specific circumstances, which refer to the circumstances relevant to a particular trust.)[160] Scott's prudent man rule could thus not adjust to general circumstances. In contrast, the traditional prudent man rule could adjust to general circumstances.[161] Therefore, trustees operating under the traditional prudent man rule were able to evaluate newer categories of investment on their merits, and determine if and how these categories might fit into a trust portfolio.[162]

4 2 3 Deficiencies in Scott's prudent man rule

Fleming's article emphasises a number of deficiencies in Scott's prudent man rule: first, the isolation approach forces trustees to hold on to poor-performing investments. Fleming's approach to the isolation approach differs from Langbein and Posner's approach. Since Fleming's focus is not on market index funds, he recognises a different problem with the rule. The emphasis of Scott's prudent man rule on the individual investment compelled trustees to hold on to poor-performing

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[155] 246.

[156] Some academics refer to changing times as "changing market conditions": Laurino (1977) *St John's LR* 723 footnote 34, or "changing economic conditions": AS Butler & DJ Flinn "What is the least that we can expect of a trustee? Exclusion of trustee duties and exemption of trustee liability" (2010) *NZLR* 459 463-464.

[157] Langbein & Posner (1976) *Am B Found Res J* 4 footnote 17.

[158] Some academics refer to changing notions of investment opportunity and risk-taking as "contemporary thinking and understanding": Butler & Flinn (2010) *NZLR* 463-464, or "prevailing theories of markets and investments": Gordon (1987) *N Y U LR* 54-55.

[159] Fleming (1977) *Real Prop Prob & Tr J* 246; Gordon (1987) *N Y U LR* 66-67.

[160] See chapter 2 para 4 2.

[161] Fleming (1977) *Real Prop Prob & Tr J* 246.

[162] 251.

investments well beyond when a normal investor would sell them.[163] A normal investor, knowing that some losses are unavoidable, would sell poor performers at a loss and invest in securities that offer a better recovery prospect.[164] However, trustees concerned with being held liable for a loss, regardless of the overall performance of the portfolio, would retain such investments hoping that their performance will improve. The isolation approach contributed to trustees' already conservative posture because it made trustees prone to avoid risky assets and only invest in "safe" securities. Fleming states that the isolation approach:[165]

> "…tends to make trustees overly conservative; their portfolios underdiversified; their policy one of concentrating on a small number of 'safe' securities; and their general approach one of adhering to predetermined bond-stock ratios regardless of market trends or conditions."

Second, Scott's prudent man rule did not adequately deal with diversification. In particular, Fleming's critique is that with regard to diversification, Scott's rule did not deal with "the necessity for it, the meaning of it and how far a trustee is subject to liability if he fails to heed it". For instance, Fleming states that section 228 of the Restatement (Second) complicated the diversification principle.[166] The section required the following:[167]

> "Except as otherwise provided by the terms of the trust, the trustee is under a duty to the beneficiary to distribute the risk of loss by a reasonable diversification of investments, unless under the circumstances it is prudent not to do so."

That diversification was required "unless under the circumstances it is prudent not to do so", suggests, according to Fleming, that diversification was not necessarily always prudent or required.[168] Fleming did not suggest that the Restatement (Second) had to change in order to provide for an absolute duty to diversify. Instead, he suggested that subsequent legislation dealing with trustee investing should be

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[163] 249.

[164] Begleiter (1999) *Maine LR* 40 footnote 140.

[165] Fleming (1977) *Real Prop Prob & Tr J* 249.

[166] 250.

[167] Haskell (1990) *North Carolina LR* 91.

[168] Fleming (1977) *Real Prop Prob & Tr J* 250.

drafted without any reference to diversification and that diversification should rather be left as a "general principle of law for court application".[169]

A third major deficiency of Scott's prudent man rule was that the rule did not impose any duty on trustees to protect trust assets from inflation.[170] Historically, inflation in the United States has outpaced the returns available from fixed-income investments.[171] Fleming warns that the loss of purchasing power through inflation presents a serious threat to every investment portfolio.[172] If the rate of inflation consistently exceeds a portfolio's rate of return, it will deplete the trust capital over time.[173] He raises the question whether or not trustees should have a duty to protect their trusts against inflation and mentions that some academics had expressed the opinion that trustees should be held liable for failure to do so.[174]

Fourth, Scott's prudent man rule did not allow for newer categories of investment.[175] Fleming acknowledges that investment in newer categories of investment may, of course, be authorised in the trust instrument. In other words, the trust instrument may give the trustees the power to invest in such investments. However, as a trust officer with a major bank, he observed that corporate trustees ordinarily did not pay much attention to such authorisations unless the investment category could be found in the language of the prudent man statute in effect in the particular state.[176] Corporate trustees feared that, despite the language of the governing instrument, a court would label such investments as speculative.[177]

4 3 Bevis Longstreth

The next major step in trust investment reform came in 1986. Bevis Longstreth, at the time a partner at a leading New York City law firm, authored a book titled "Modern Investment Management and the Prudent Man Rule". Begleiter suggests that because of the position of the author, it is likely that the information contained in

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[169] 250.
[170] 249.
[171] Phillips (1997) *Wash & Lee LR* 343-344.
[172] Fleming (1977) *Real Prop Prob & Tr J* 249.
[173] Johnson (1993) *Syracuse LR* 1181.
[174] Fleming (1977) *Real Prop Prob & Tr J* 249.
[175] 251.
[176] 251.
[177] Begleiter (1999) *Maine LR* 40.

the book was more widely read than previous criticisms of Scott's prudent man rule.[178]

In 1986, Scott's prudent man rule governed, in one form or another, the overwhelming majority of the funds held by trustees in the United States.[179] The importance of Longstreth's book is that it collects aspects of Scott's prudent man rule and MPT in one place; aspects which had previously been separately treated. More specifically, it combines descriptions of the history and the status of Scott's prudent man rule[180] with an explanation of the lessons of MPT.[181]

Longstreth believed that a gap existed between what was permitted under traditional legal notions of prudence and what trustees in their best judgment wanted to do.[182] To test his proposition, he undertook to survey 200 trustees on their investment practices. The trust departments of fifty of the largest banks in the United States were included in the survey.[183] The survey revealed that many trustees, particularly corporate trustees, believed that existing doctrine prohibited or rendered questionable many new or unconventional investment products or techniques.[184] The details of the survey gave great weight to Longstreth's conclusion that the rules governing trust investments needed modernisation. Referring to the gap that existed between what was permitted under traditional legal notions of prudence and what trustees in their best judgment wanted to do, he states:[185]

> "A modern interpretation of prudence is needed to reconcile these differences. It should draw upon the broadest possible currents of change. It should recognize the important and established principle of finance economics that nothing useful can be said about an investment in the abstract; it can only be judged in terms of its impact on the whole portfolio and the purposes for which the portfolio is held. A modern paradigm for prudence, then, would shift the focus from the disembodied investment to the fiduciary, the portfolio, and its purpose."

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[178] 41.

[179] Longstreth *Modern Investment Management* 13 and 39.

[180] See chapters 1 and 2 of Longstreth *Modern Investment Management*.

[181] See chapters 3 and 4 of Longstreth *Modern Investment Management*.

[182] Longstreth *Modern Investment Management* 5

[183] 5.

[184] 6; Begleiter (1999) *Maine LR* 41.

[185] Longstreth *Modern Investment Management* 156.

Longstreth recommended major changes to Scott's prudent man rule,[186] and called for the American Law Institute to formulate a new Restatement of Trusts that would elaborate and refine the recommendations that he made.[187] The changes that Longstreth recommended are analogous to Gordon's recommendations discussed below.[188]

4 4 Jeffrey Gordon

4 4 1 Introduction

Jeffrey Gordon, a professor of law who collaborated with Longstreth and wrote one of the appendices to Longstreth's book, published an influential article expanding on that appendix. Gordon criticises Scott for transforming the traditional prudent man rule into a more constraining and less flexible rule.[189] Gordon refers to the traditional prudent man rule as the "unconstrained prudent man rule",[190] and to Scott's prudent man rule as the "constrained prudent man rule".[191]

Gordon argues that what counts as prudence must be "understood in light of our best current understanding of market and investor behavior".[192] According to him, prudence does not mean conservative investing, but rather embodies the idea of "earning the maximum possible return for the chosen level of risk".[193] Gordon states that the constrained prudent man rule denied trust beneficiaries effective investment management that could raise returns and lower risks.[194] In simpler terms, the rule deterred trustees from doing the best possible job they were capable of doing for beneficiaries.[195] Consequently, because of the rule's evolution, it actually prevented trustees from acting prudently.[196] Gordon believed that MPT offered a better account

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[186] 156-157.

[187] 158.

[188] See para 4 4 4 below.

[189] Gordon (1987) *N Y U LR* 58.

[190] 58 and 90.

[191] 57-58.

[192] 66.

[193] 62; Sterk (2010) *Cornell LR* 853.

[194] Gordon (1987) *N Y U LR* 54.

[195] Johnson (1993) *Syracuse LR* 1177.

[196] Gordon (1987) *N Y U LR* 62; Fleming (1977) *Real Prop Prob & Tr J* 247 footnote 20; Rizzi (1975) *Notre Dame Law* 528.

of risk and safety, and thus a better guide to prudent investment.[197] In his article, he presents the case for an investment rule in terms of MPT.

Gordon's article is important in the development of trustee investment management in the United States for three reasons: first, he identifies three key decisions made by Scott that led to the development of a more constraining prudent man rule; second, he explains why Scott's prudent man rule has survived over the years; and third, Gordon discusses those elements of Scott's rule that required change in order to accommodate MPT.

4 4 2 Scott's key decisions

Gordon identifies three key decisions made by Scott in his treatise and as the reporter of the first two restatements, which led courts to develop and apply the constrained prudent man rule rather than the original, more flexible rule stated in *Amory*.

4 4 2 1 Preservation of the estate

Scott altered the traditional prudent man rule to require a more conservative benchmark of prudence than was previously required.[198] Putnam J in *Amory* required the prudence of persons seeking "permanent disposition of their funds".[199] But, instead, Scott prescribed the prudence of one seeking primarily the "preservation of the estate". The Restatement (Second) provided:[200]

> "In making investments of trust funds the trustee is under a duty to the beneficiary… to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived."

The concept of permanent disposition of funds (or "permanence of investment") referred to transactions that were not entered into for a quick turnover or profit.[201] An investment strategy aimed at permanent disposition could, for example, include "a

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[197] Gordon (1987) *N Y U LR* 54-55.

[198] 58.

[199] *Harvard College v Amory* 26 Mass. (9 Pick.) 446 (1830) 461.

[200] Longstreth *Modern Investment Management* 42.

[201] Shattuck (1951) *Ohio St LJ* 517.

buy-and-hold portfolio of common stocks at a higher level of risk and expected return". On the other hand, an investment strategy intended to preserve capital would be more cautious than one aimed at permanent disposition.[202]

4 4 2 2 Safeguarding the property of others

Instead of an investment standard based on how prudent men conduct their *own* affairs, Scott prescribed the more constraining standard of how prudent men safeguard the property of *others.* In *Amory*, Putnam J spoke of the care that men of prudence exercise in the management of "their own affairs".[203] Fleming interprets this to mean that:[204]

> "[I]f a trustee conforms his actions to what other people in the financial community are currently doing and saying in regard to the investment of their own investable funds and if he uses his best judgment in what he does, he will be doing all that can reasonably be expected of him."

With regard to general trust administration, Scott charged trustees with a duty to administer their trusts with such care and skill as men of ordinary prudence would exercise in dealing with their own property.[205] However, the standard governing investment decisions added a further requirement of caution to trustees' general duties of care and skill. In Scott's work, the concept of managing their own affairs became "safeguarding the property of others".[206] As a result of the change, the "prudent investor test" became the "prudent trustee test" – the implication being that trustees had to use "especially safe means" to attain a desired level of investment safety, rather than "ordinarily prudent means".[207]

Why did Scott make this doctrinal change? Gordon suggests that Scott made the assumption that the preservation of the trust estate ought to be trustees' primary goal. Based on this assumption, Scott concluded that prudent trustees may not

[202] Gordon (1987) *N Y U LR* 59.

[203] *Harvard College v Amory* 26 Mass. (9 Pick.) 446 (1830) 461.

[204] Fleming (1977) *Real Prop Prob & Tr J* 245-246.

[205] Longstreth *Modern Investment Management* 13.

[206] Fleming (1977) *Real Prop Prob & Tr J* 246.

[207] Gordon (1987) *N Y U LR* 60.

pursue this goal in ways which were otherwise acceptable to prudent investors.[208] It was thus no longer sufficient to ask how prudent men would deal with their own property since "men of prudence may well take risks in making investments which trustees are not justified in taking".[209]

4 4 2 3 Prudent and imprudent investments

Scott's work drew a distinction between prudent and imprudent investments.[210] Scott's Treatise and the Restatements permitted the following investments: government bonds; first mortgages on land; and corporate bonds of certain classes that are supposed to be especially free from risk.[211] Generally impermissible investments included: margin purchases of securities; speculative shares of stock; bonds selling at a large discount owing to uncertainty of payment at maturity; securities in new and untried enterprises; and land or other things purchased for the purpose of resale.[212] The effect of the prudent/imprudent distinction was that trustees were unwilling to invest in certain securities because of the likelihood that a Scott-influenced court would regard such investments as speculative.[213]

This unwillingness of trustees to invest in certain securities created a special problem for a financial model such as MPT. One of the lessons of MPT is that no security is inherently good or bad or prohibited *per se* as too risky. MPT further teaches that it is possible to reduce a portfolio's risk by adding to it a risky asset that moves inversely to the other investments of the portfolio.[214] Therefore, in order to attain optimal portfolio diversification, trustees should mix risky assets with relatively risk-free assets.[215] The problem with the prudent/imprudent distinction was that because it prohibited certain securities, it prevented trustees from attaining optimal diversification.[216]

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[208] 60.

[209] Longstreth *Modern Investment Management* 13.

[210] 13; Gordon (1987) *N Y U LR* 61.

[211] Longstreth *Modern Investment Management* 13-14.

[212] 14; Gordon (1987) *N Y U LR* 61.

[213] Gordon (1987) *N Y U LR* 61.

[214] See chapter 3 para 4.

[215] Halbach (1992) *Real Prop Prob & Tr J* 430; Gordon (1987) *N Y U LR* 61.

[216] Gordon (1987) *N Y U LR* 61.

4 4 3 The persistence of the constrained rule

When one considers Gordon's criticism of the constrained prudent man rule, the question can be raised: why has the rule persisted over the years? Gordon's article offers an explanation for the persistence of the constrained rule. Moreover, Gordon believes that if the courts came to understand why the rule has persisted, they would be more receptive to the argument for its modernisation.[217]

4 4 3 1 The authoritative commentary

Gordon blames the authoritative commentary for having a constraining influence on the development of the common law. Gordon explains that judges regularly consulted the authoritative commentary, such as Scott's Treatise and the Restatements,[218] in order to justify their decisions:[219]

> "Judges presumably want to justify their decisions through a cogent analysis of the applicable law. But even an energetic judge, aided by energetic law clerks, would face an impossible workload if she had to synthesize complex bodies of law from scratch for every opinion. Rather than rely on an account of the law provided by one of the parties, a judge is likely to turn to a disinterested source."

The authoritative commentary claimed to present the legal rules properly derived from the cases and that these rules are simply there to be applied.[220] However, Gordon highlights the limitation of these rules:[221]

> "These rules, divorced from the factual context that gives them shading and texture, stand as an abstract set of instructions."

The danger of continuously resorting to the authoritative commentary was that it prevented changes in outmoded legal rules. The reason for this is that judges were relying on previously established legal doctrine without "examining the rationale for the creation of the doctrine or considering whether that rationale remains valid in

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[217] 55.
[218] 63.
[219] 64.
[220] 63-64.
[221] 63.

changed circumstances".[222] The authoritative commentary thus inhibited the common law process of reinterpretation and change".[223]

4 4 3 2 Unwillingness to litigate

Litigation is the means by which parties attempt to persuade judges that a particular rule is adverse to their interests. Gordon provides the following example:[224]

> "Imagine that a particular group of beneficiaries feels that management of their trust is hampered by a narrow conception of prudence that bars investment of part of the portfolio in a promising venture capital pool."

The beneficiaries in the example will assess their chances of success. If they believe that their chances of success are positive, they will press the court to re-examine its narrow conception of prudence. Gordon states that if judges are repeatedly pressed on a rule, the rule might change:[225]

> "Even if a particular challenge fails, a steady drumbeat of litigation may have a cumulative effect; important distinctions and qualifications may emerge, eventually leading to a new rule."

Therefore, the possibility exists that new rules may emerge out of litigation. However, the authoritative commentary reduced the "variation in individual estimates of success".[226] In other words, it reduced the extent to which the parties to a dispute disagreed as to the probable outcome. Litigants are significantly influenced by the probable outcome of a case. Litigation challenging the established rule becomes less likely if all parties to a dispute are in close agreement as to the probable outcome.[227] Consequently, the ability of the courts to change trust investment law was restricted because litigants were unwilling to press suits to judgment.

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[222] Blair & Heggestad (1978) *Law Forum* 79.
[223] Gordon (1987) *N Y U LR* 56.
[224] 65.
[225] 64.
[226] 65.
[227] 65-66.

4 4 3 3 Contracting around limitations

Settlors of large trusts usually receive sophisticated legal advice and are most likely to contract around investment limitations otherwise set by law. Indeed, at the time of Gordon's article, well-advised settlors employed such provisions with increasing frequency. Therefore, beneficiaries of large trusts had no need to apply to the courts for a better investment rule. As a result, the class of beneficiaries with the "most substantial economic stake" were excluded from the pool of potential litigants.[228]

4 4 3 4 Unresponsiveness to MPT

Gordon states that the education of courts is often accomplished through litigation.[229] Unfortunately, lawyers did not argue the gains of MPT to the courts:[230]

> "… not one of the reported surcharge cases in the 1970s or 1980s seems to have been argued on portfolio theory grounds, even where such an argument might have been decisive."

Under these circumstances and given the complexity of MPT, it is hardly surprising that the courts did not adopt a MPT approach *sua sponte*.[231]

4 4 4 Changes to the constrained prudent man rule

Gordon discusses those elements of the constrained prudent man rule (Scott's prudent man rule) that required change to accommodate MPT as well as those that did not require change. First, trustees should be permitted to use any investment vehicle or technique reasonably expected to achieve maximum return at the appropriate level of risk. Assuming due caution in selecting the portfolio risk level and due care in managing the portfolio consistent with the permitted risk, the trustees' investment decisions would be regarded as prudent.[232]

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[228] 75-76.

[229] 91.

[230] 90-91.

[231] Gordon (1987) *N Y U LR 90*-91; Haskell (1990) *North Carolina LR* 87.

[232] Gordon (1987) *N Y U LR* 96. For a discussion of the duty of caution, see para 5 4 1 below.

Second, trustees' investment decisions regarding individual assets should be evaluated not in isolation but in the context of the entire trust portfolio and as a part of an overall investment strategy.[233] Gordon thus called for the total portfolio approach to replace the isolation approach.

Third, Gordon proposed that diversification became mandatory (except in special circumstances). Through his proposal, he rejected the optional diversification principle that was in force in New York. The prevailing view at the time was that the purpose of diversification was merely to "avoid the risk of loss"; a view also rejected by Gordon. Rather, for him, the importance of diversification is that it "increases expected return at the chosen risk level".[234]

Fourth, the "anti-netting rule" should be retained.[235] The rule pertains to balancing losses arising from one or more breaches of trust against gains from other sources.[236] Gordon states that the rule is not inconsistent with MPT.[237]

Fifth, the traditional rules governing how trustees allocate the receipts from trust investments between income and capital beneficiaries had to change. Gordon views these allocation rules as profoundly inconsistent with MPT.[238] The solution for him was to make "total return investing" readily available to trustees. The term "total return investing" requires explaining.

At the time of Gordon's article, it was settled law that when trustees made investment decisions, they had to keep in mind that the law required income to be allocated to income beneficiaries and capital to be allocated to capital beneficiaries.[239] This rule is hereafter referred to as the "traditional distribution rule". This aspect of trust law is cast into doubt by the acceptance of MPT. A key principle of MPT is that it is artificial to distinguish between income and capital when investing.[240] MPT assesses investment options based on its overall total return

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[233] Gordon (1987) *N Y U LR* 93.

[234] 97-98.

[235] For a detailed discussion of the anti-netting rule, see chapter 7 para 7.

[236] Gordon (1987) *N Y U LR* 97; Schwartzel (2002) *Baylor LR* 820; Begleiter (1999) *Maine LR* 42 footnote 166.

[237] Gordon (1987) *N Y U LR* 97.

[238] 99.

[239] 99.

[240] New Zealand Law Commission *Review of the Law of Trusts – Preferred Approach* (2012) Issues paper 31 95; Begleiter (1999) *Maine LR* 59.

regardless of whether the investments are correctly categorised as income or capital.[241] Hereafter, this approach is referred to as "total return investing".

When total return investing is incorporated into trust law, the investment decision-making of trustees is separated from distributional issues.[242] Trustees following a MPT-driven regime must follow a two-step procedure. The first step is to invest for the maximum total return at a given level of risk,[243] and then, in a separate and subsequent step, to allocate the return fairly between the beneficiaries.[244] Several authors have noted that this two-step procedure could create a conflict between income and capital beneficiaries.[245] Solutions to this potential conflict are discussed in chapter 7.[246]

Without being able to use total return investing, trustees are unable to invest for maximum total return at a given level of risk.[247] Therefore, total return investing is necessary for trustees to be in the best position to employ the risk/return analysis effectively to obtain the maximum advantage for their trusts:[248]

> "[Total return investing] gives trustees greater flexibility in assessing tradeoffs between risk and reward by providing a much broader view of what constitutes return and, consequently, what justifies increased risks for the portfolio."

4 5 The critics' influence

Schwartzel provides a good summary of the changes the critics called for:[249]

> "… the critics argued that those aspects of the prudent man rule which discourage trustees from adopting generally accepted portfolio management strategies and from devoting more attention to preservation of the purchasing power of the trust principal needed to be reformed and updated and that the focus of fiduciary investment policy

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241 Gordon (1987) *N Y U LR* 99-100.

242 British Columbia Law Institute *Total Return Investing by Trustees* (2001) Report 16 8.

243 Begleiter (1999) *Maine LR* 59.

244 JC Dobris "The probate world at the end of the century: is a new Principle and Income Act in your future?" (1993) 28 *Real Prop Prob & Tr J* 393 412.

245 Begleiter (1999) *Maine LR* 59.

246 See chapter 7 para 5.

247 British Columbia Law Institute *Total Return Investing* 8.

248 Phillips (1997) *Wash & Lee LR* 335.

249 Schwartzel (2002) *Baylor LR* 715.

should not be on the 'avoidance of risk by trustees but for their prudent management of risk'."

The critics greatly influenced the development of trustees' investment standards. The criticisms of Scott's prudent man rule from Langbein and Posner, Fleming, Longstreth, and Gordon, together with other academics,[250] led to the formulation and adoption of the Restatement (Third) and later the promulgation of the Uniform Prudent Investor Act ("UPIA").[251] Also, an entirely new rule developed – the "prudent investor rule".

4 5 1 The Restatement (Third)

When the American Law Institute began the process of preparing the Restatement (Third), it first covered the "prudent investor rule". Sterk states that this reflected the importance of the topic to trust lawyers at the time.[252] The volume in the Restatement (Third) on the prudent investor rule was approved by the American Law Institute at its 1990 meeting and published in 1992.[253] The reporter of the Restatement (Third) is Professor Edward C Halbach.[254] The aim of the volume is to "modernize trust investment law and to restore the generality and flexibility of the original prudent man rule".[255] The Restatement (Third) implements many of the changes advocated by Scott's critics.[256] Importantly, the prudent investor rule as described in the Restatement (Third) includes all of the major principles of MPT.[257] Hereafter, the rule is referred to as the "prudent investor rule of the Restatement (Third)".

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[250] Among others, Rizzi (1975) *Notre Dame Law*, HE Bines "Modern portfolio theory and investment management law: refinement of legal doctrine" (1976) 76 *Columbia LR*, Laurino (1977) *St John's LR*, Blair & Heggestad (1978) *Law Forum,* and Bobo (1984) *Emory LJ.*

[251] Begleiter (1999) *Maine LR* 28.

[252] Sterk (2010) *Cornell LR* 862.

[253] Langbein (1994) *Missouri LR* 116.

[254] Halbach (1991) *Iowa LR* 1151.

[255] Schwartzel (2002) *Baylor LR* 703.

[256] CR Radigan & JF Hillman "The evolution of prudence in trustee investing" (2013) *N Y LJ* 1 2.

[257] Haskell (1990) *North Carolina LR* 88.

4 5 2 UPIA

In 1991, the National Conference on Commissioners for on Uniform State Law ("NCCUSL") began a three-year project to draft a codified version of the revised principles of the Restatement (Third) into a uniform law.[258] In 1994, the NCCUSL promulgated the UPIA,[259] incorporating many of the concepts from the Restatement (Third).[260] The UPIA also includes the tenets of MPT. Ruce states that the UPIA:[261]

> "…applies a broad set of reforms to the prudent man investment doctrine, reflecting the changes and a new understanding of the functions and roles of investment portfolios in fiduciary accounts, including efficient markets and MPT."

5 New York's prudent investor rule

5 1 Promulgation of the Prudent Investor Act

Although the Restatement (Third) was promulgated in 1992,[262] New York's prudent man rule continued to be applied to investments until 31 December 1994. In 1991, the Estate, Powers and Trusts Law Advisory Committee ("EPTL Committee") recommended an examination and revision of the articles of the Estate, Powers and Trusts Law and the Surrogate's Court Procedure Act ("SCPA"). The EPTL Committee later changed into the EPTL-SCPA Legislative Advisory Committee ("EPTL-SCPA Committee"). Led by former surrogate C Raymond Radigan, the EPTL-SCPA Committee in its Third Report proposed legislation that would serve to codify a prudent investor rule for trustees. Upon the committee's recommendations, the New York State Legislature enacted the Prudent Investor Act.[263] The enacted statute is effective as to investments made or held by trustees on or after

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[258] Ruce (2012) *South Texas LR* 678. The purpose of the NCCUSL is to draft proposals for uniform and model laws and work toward their enactment in the different states: Ruce (2012) *South Texas LR* 677; Hauser "United States" in Kaplan et al *Trusts in Prime Jurisdictions* 319.

[259] Begleiter (1999) *Maine LR* 28.

[260] Schwartzel (2002) *Baylor LR* 715.

[261] Ruce (2012) *South Texas LR* 678.

[262] Langbein (1994) *Missouri LR* 105.

[263] Radigan (05-09-2010) *Ruskin Moscou Faltischek* <http://www.rmfpc.com/advisory-committee-prudent-investor-act/> (accessed 04-11-2016) 1-2.

1 January 1995.[264] Based on the Restatement (Third), the Act includes all major principles of MPT.[265] The Act codifies a prudent investor rule for New York, thereby replacing New York's prudent man rule. The new rule is hereafter referred to as "New York's prudent investor rule".

5 2 Standard of care and loyalty

The elements of care, skill, and caution are the essence of New York's prudent investor rule. Trustees meant to satisfy the prudent investor standard under the Prudent Investor Act are required to:[266]

> "…exercise reasonable care, skill and caution to make and implement investment and management decisions as a prudent investor would for the entire portfolio, taking into account the purposes and terms and provisions of the governing instrument."

It is worth pointing out that the wording of the section intentionally avoids the controversy over whether trustees are to invest as prudent investors would in managing their *own* funds or in managing the funds of *others*.[267]

The Act changes the standard of care from that of an ordinary prudent *man* to that of an ordinary prudent *investor*.[268] Trustees must invest in those investments in which a prudent investor would invest.[269] New York's prudent investor rule requires trustees to only choose an investment strategy that is appropriate to the skills that they possess.[270] In many cases, trustees of ordinary skills, such as family members and friends, will lack the knowledge and expertise required to comply with the new rule. This does not mean that trustees lacking special investment skills are prevented from serving as trustees. However, family members and friends acting as trustees will have to do much more than before in order to meet the obligations under the prudent investor rule. Most trustees will have to seek outside professional help to

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[264] S 11-2.3(a) of the Prudent Investor Act.

[265] Radigan & Hillman (2013) *N Y LJ* 3; see para 5 3 below.

[266] S 11-2.3(b)(2) of the Prudent Investor Act; Panico (2009) *T & T* 102.

[267] Halbach (1991) *Iowa LR* 1155 footnote 19.

[268] Schwartzel (2002) *Baylor LR* 795.

[269] CS Weigl "Prudent investor rule and modern portfolio theory" (2014) 33 *Est Tr & Pensions J* 145 154.

[270] Halbach (1991) *Iowa LR* 1159.

meet their duty of care as prudent investors.[271] The appropriate and necessary skills are available to trustees through competent advice or proper delegation. For this reason, the Act makes dramatically broader provision for obtaining advice and delegating investment functions than traditional trust doctrine.[272]

In addition to the duties of reasonable care, skill and caution, trustees in New York owe a duty of loyalty to beneficiaries.[273] The duty is not imposed upon trustees through any requirement of the trust document, but through the relationship between trustees and beneficiaries.[274] The duty of loyalty requires trustees to administer trust property solely in the interest of trust beneficiaries.[275] In modern times it has been construed to apply primarily to instances of self-dealing by trustees.[276]

5 3 The major changes to existing law

The Prudent Investor Act made five major changes to trustee investment management in New York: first, New York's prudent investor rule applies as to the entire portfolio rather than to a particular investment viewed in isolation. The rule thus sanctions the total portfolio approach. Authority for the total portfolio approach is found in three sections in the Act. The Act requires a trustee to:

> "… make and implement investment and management decisions as a prudent investor would for the entire portfolio, taking into account the purposes and terms and provisions of the governing instrument."[277]

> "…pursue an overall investment strategy… in accordance with risk and return objectives reasonably suited to the entire portfolio."[278]

> "… [consider] the role that each investment or course of action plays within the overall portfolio."[279]

[271] Schwartzel (2002) *Baylor LR* 796.

[272] Halbach (1991) *Iowa LR* 1159 footnote 36.

[273] IW MacLean "Exculpatory clauses in inter vivos trusts: what remains of a trustee's duty of undivided loyalty?" (2004) 37 *Tr & Est L Newsl* 5 5.

[274] Bobo (1984) *Emory LJ* 1070.

[275] IM Bloom & WP LaPiana *Final Report on the EPTL-SCPA Legislative Advisory Committee's 6th Report* (2016) A-147.

[276] Bobo (1984) *Emory LJ* 1070.

[277] S 11-2.3(b)(2) of the Prudent Investor Act.

[278] S 11-2.3(b)(3)(A).

Second, New York's prudent investor rule authorises trustees to invest in any type of investment since no particular investment is prudent or imprudent *per se*.[280] Trustees are given greater flexibility in choosing investments, provided that the investment advances the overall investment plan and that the investment plan is prudent.[281]

Third, a duty to diversify trust assets is imposed on trustees unless the trustees reasonably determine that it is in the interests of the beneficiaries not to diversify:[282]

> "The prudent investor standard requires a trustee to: … diversify assets unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument…"

The Act further requires that trustees must within a reasonable time after the creation of the trust relationship determine whether to retain or dispose of initial assets.[283] Before the Act, trustees had no absolute duty to diversify. The reform regarding the duty of diversification is thus a significant broadening of New York trust law.

Fourth, New York's prudent investor rule requires trustees to consider "the expected total return of the portfolio (including both income and appreciation of capital)".[284] Since "return" in MPT means total return,[285] this reform makes explicit the connection between New York's prudent investor rule and MPT. The operation of total return investing in New York is discussed in detail in chapter 7.[286]

Fifth, New York's prudent investor rule permits trustees to delegate investment and management functions in certain instances.[287] Before the Act, investment decision-making was seen as personal, and trustees could not divest it.[288] Begleiter

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279 S 11-2.3(b)(3)(B).

280 S 11-2.3(b)(4)(A).

281 Gordon (1987) *N Y U LR* 93; Radigan (05-09-2010) *Ruskin Moscou Faltischek* <http://www.rmfpc.com/ advisory-committee-prudent-investor-act/> (accessed 04-11-2016) 3.

282 S 11-2.3(b)(3)(C) of the Prudent Investor Act.

283 S 11-2.3(b)(3)(D).

284 S 11-2.3(b)(3)(B).

285 Begleiter (1999) *Maine LR* 59.

286 See chapter 7 para 5 5.

287 S 11-2.3(c) of the Prudent Investor Act; Bloom & LaPiana *Final Report* A-159.

288 Radigan et al (2011) *N Y LJ* 2.

states that the criticism from Langbein and Posner's 1976 article laid the groundwork for the revision of this power fifteen years after their article.[289] In terms of the change, delegation is appropriate where the investment expertise of trustees is limited. Trustees are allowed to delegate investment decisions to an individual or institution with the necessary knowledge.[290]

There is one change that the Prudent Investor Act did not make that is worth pointing out: the Act does not abolish the anti-netting rule.[291] This is in accordance with the Restatement (Third), which preserves the anti-netting rule of the Restatement (Second).[292]

5 4 Key features of New York's prudent investor rule

5 4 1 Duty of caution

New York's prudent investor rule transforms the role of a trustee from that of a wealth conservator (who avoids risk) to that of a wealth manager (who consciously assumes and manages risk).[293] Two changes to existing law contributed to the transformation of the trustee's role: first, the Prudent Investor Act disavows the emphasis in older law on avoiding "speculative" or "risky" investments;[294] and second, in addition to the duties of reasonable care and loyalty, trustees owe a duty of caution.[295] The duty of caution requires trustees to assure a suitable risk level in light of the needs of the trust they are administering.[296]

The change from wealth conservator to wealth manager is important because trusts differ considerably in their risk-bearing capacities.[297] Low levels of risk may be appropriate in some trust settings but inappropriate in others.[298] For example, a trust whose main purpose is to support an elderly widow of modest means has a low risk

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[289] Begleiter (1999) *Maine LR* 39.

[290] Radigan (05-09-2010) *Ruskin Moscou Faltischek* <http://www.rmfpc.com/advisory-committee-prudent-investor-act/> (accessed 04-11-2016) 2.

[291] Bloom & LaPiana *Final Report* A-210.

[292] Schwartzel (2002) *Baylor LR* 817.

[293] 716.

[294] See para 5 3 above.

[295] S 11-2.3(b)(2) of the Prudent Investor Act.

[296] Schwartzel (2002) *Baylor LR* 722 footnote 87.

[297] 749 footnote 179.

[298] 716.

tolerance.[299] An example of a somewhat higher risk tolerance is a trust for a middle-aged man with an adequate income flow and a desire to provide for his retirement. Such a person would be well-served if the trustees invest in long-term growth securities.[300] The circumstances of some trusts might even justify a strategy of seeking not merely to preserve but even to enhance the real value of capital. For example, a young scion of great wealth seeking a potentially higher rate of return would be best served by a high risk-reward strategy.[301]

5 4 2 Cost consciousness

The Prudent Investor Act provides that a trustee is authorised to incur costs only to the extent that the costs are "appropriate and reasonable in relation to the purposes of the governing instrument, the assets held by the trustee and the skills of the trustee".[302] Halbach refers to this duty as "the duty to be cost conscious in investing".[303] The duty to be cost conscious is at least partially derived from both the increased requirement of diversification,[304] and the ECMH.[305]

The Restatement (Third) elaborates on the scope of the duty and provides that trustees must weigh up the costs of different products:[306]

> "[I]t is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio."

In the context of the debate on active versus passive management,[307] the duty requires that trustees ought to consider the cost of using an active manager as opposed to buying a (presumably less expensive) market index fund. Admittedly, active management strategies are necessary in certain situations.[308] Trustees who

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[299] R Sitkoff "An agency costs theory of trust law" (2004) 89 *Cornell LR* 621 657.

[300] Radigan & Hillman (2013) *N Y LJ* 3.

[301] Schwartzel (2002) *Baylor LR* 741 footnote 153.

[302] S 11-2.3(b)(4)(D) of the Prudent Investor Act.

[303] Halbach (1991) *Iowa LR* 1174.

[304] Begleiter (1999) *Maine LR* 61.

[305] RB Wolf "Defeating the duty to disappoint equally – the total return trust" (1997) 32 *Real Prop Prob & Tr J* 45 64. For a discussion of ECMH, see chapter 3 para 3 4.

[306] Schwartzel (2002) *Baylor LR* 791.

[307] See chapter 3 para 6 3.

[308] See chapter 3 para 6 3.

apply active management are required to justify the increased costs by showing that, at the time the decision was made, the advantages of active management outweighed those of a passive strategy.[309]

5 4 3 Protecting against inflation

New York's prudent man rule did not impose a duty on trustees to protect against inflation. Trustees had to preserve trust capital – defined in nominal as opposed to real terms.[310] The loss of purchasing power through inflation presents a serious threat to every trust estate. If the rate of inflation consistently exceeds a portfolio's rate of return, it will deplete the trust capital over time. This threat to the trust capital affects both income and capital beneficiaries. The preservation of real value has obvious importance to capital beneficiaries, but it is also important to income beneficiaries as a means of protecting the purchasing power of their income flow over the years.[311]

At first sight, it might appear that the Prudent Investor Act does not change the position. The section that lists the requirements of the prudent investor standard only requires that trustees *consider* the possible effect of inflation or deflation.[312] The section should, however, not be read in isolation. It is submitted that the position in New York concerning inflation has in fact changed. In terms of New York's prudent investor rule, trustees owe a duty of caution to beneficiaries:[313]

> "A trustee shall exercise reasonable care, skill and caution to make and implement investment and management decisions as a prudent investor would for the entire portfolio…"

The Restatement (Third) discusses the necessity of preserving the purchasing power of the trust property as part of the requirement of the duty of caution:[314]

> "[T]his requirement of caution requires the trustee to invest with a view both to safety of the capital and to securing a reasonable return. 'Safety' of capital includes not only the

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[309] Begleiter (1999) *Maine LR* 62.

[310] See paras 4 3 1 and 5 2 3 above.

[311] Schwartzel (2002) *Baylor LR* 773.

[312] S 11-2.3(b)(3)(B) of the Prudent Investor Act.

[313] S 11-2.3(b)(2).

[314] Begleiter (1999) *Maine LR* 58 footnote 247.

objective of protecting the trust property from the risk of loss of nominal value but, ordinarily, also a goal of preserving its real value – that is, seeking to avoid or reduce loss of the trust estate's purchasing power as a result of inflation."

As mentioned above, New York's prudent investor rule has changed the trustee's role from that of a wealth conservator who avoids risk to that of a wealth manager who manages risk.[315] The Restatement (Third) stresses that risk management is concerned with more than the loss of dollar value. Risk management takes account of all hazards, including the danger of inflation.[316]

In summary, the Prudent Investor Act does not impose an affirmative duty on trustees to invest with a view to protect against inflation. Rather, because of the duty of caution, trustees must consider the objective of the particular trust and then use their best judgment to decide whether or not the objective of the trust constitutes the preservation of the trust estate in nominal or real terms. Furthermore, considering that the new role of a trustee is that of wealth manager, the expectation is that a court will justify an investment strategy only aimed at preserving the estate in nominal terms, such as investing solely in fixed-income investments, in very few circumstances.

5 5 The effect of the new standard

In *Janes*, the New York State Court of Appeals dealt with the question whether or not a trustee acted imprudently. Even though the case does not refer to the Restatement (Third) or the Prudent Investor Act as authority,[317] it appears that the court was influenced by these sources.

In *Janes*, the testator died in 1973, survived solely by his wife ("Mrs Janes") who was then 72 years of age. Among the assets in the estate were securities worth over

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[315] See para 5 4 1 above.

[316] RJ Aalberts & PS Poon "Derivatives and the modern prudent investor rule: too risky or too necessary?" (2006) 67 *Ohio St LJ* 525 559 footnote 226.

[317] The only reference to the Prudent Investor Act is found in a footnote on page 56 of *Matter of Janes* 90 N.Y.2d 41 (1997): "The recently enacted Prudent Investor Act requires a trustee 'to diversify assets unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument'. The act applies to investments 'made or held' by a trustee on or after January 1, 1995 and, thus, does not apply to the matter before us."

$3 million, with almost $1.8 million of the securities consisting of stock of Eastman Kodak Company ("Kodak stock").[318]

The testator bequeathed most of his estate to three trusts. First, the testator created a marital deduction trust consisting of approximately 50% of the estate's assets, the income of which was to be paid to Mrs Janes for her life. Second, the testator established a charitable trust of approximately 25% of the estate's assets that directed annual distributions to selected charities. Finally, a third trust comprised the balance of the estate's assets and directed that the income therefrom be paid to Mrs Janes for her life, with the remainder pouring over into the charitable trust upon her death.[319]

In 1981, the trustee of the trusts, Lincoln First Bank, sought a judicial settlement of its account. The value of the Kodak stock had dropped to about one-third of its date-of-death value. Objections to the accounts were originally filed by Mrs Janes in 1982, and subsequently by the charitable beneficiaries of the trusts. The charitable beneficiaries alleged that the trustee acted imprudently in failing to sell at least some of the Kodak stock.[320]

The case was decided under New York's prudent man rule stated in the prior version of its trusts investment statute. The Prudent Investor Act did not apply since all investments in this case were made prior to 1 January 1995.[321] The New York State Court of Appeals held that the high concentration in Kodak stock was imprudent and held the trustee liable for losses.[322]

As already mentioned, the case does not refer to the Restatement (Third) or the Prudent Investor Act as authority. However, it does seem as if the court was influenced by these sources. Begleiter states that:[323]

> "The major focus of the opinion of the Court of Appeals is the relation of the asset to the total portfolio and the failure of the executor to develop, implement, and monitor an

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[318] *Matter of Janes* 90 N.Y.2d 41 (1997) 46.

[319] 47.

[320] 48.

[321] S 11-2.3(a) of the Prudent Investor Act.

[322] NC Klein "Augmenting liability risks for trustees in the light of modern financial theory – the potential of the prudent investor rule and its portfolio diversification requirement" (2014) 20 *T & T* 692 696; SE Sterk "The New York Court of Appeals: 150 years of leading decisions" (1998) 48 *Syracuse LR* 1391 1413.

[323] Begleiter (1999) *Maine LR* 72.

investment plan for the estate. The opinion is consistent with the Restatement [Third] and modern portfolio theory and represents a sharp departure from prior analysis."

6 Criticism of the prudent investor rule

A major criticism of the prudent investor rule of the Restatement (Third) is that it establishes too permissive a standard for the evaluation of trustee behaviour. Because of the similarities between the prudent investor rule of the Restatement (Third) and New York's prudent investor rule, the criticism discussed here is relevant to both rules. The claim is that the prudent investor rule resembles the Business Judgment Rule ("BJR"). Such a standard of review shields trustees from liability for their investment decisions.[324] Properly understood, however, the prudent investor rule does not resemble the BJR since the prudent investor rule includes a duty of caution. Contrasting the approach in corporate law and trust law is instructive.

The BJR can be understood in light of the particular duties of a corporate director. Gordon provides the following definition of the BJR:[325]

> "A disinterested director who exercises reasonable care in informing himself about a business decision, and who rationally believes the decision to be in the corporation's best interests, cannot be held liable if the decision turns out badly."

The Companies Act 71 of 2008 ("Companies Act") codifies the BJR into South African law and lists the requirements for the BJR to operate. These requirements are similar to the requirements found in Gordon's definition. The BJR will operate if the following requirements are met:[326] the decision must be an informed one; the director must have no financial interest in the decision; and the director must have a rational basis for believing (and the director must in fact believe) that the decision is in the best interests of the company.

In the corporate context, one of the rationales for the BJR is that it encourages directors to take business risks.[327] Business risk-taking is essentially beneficial to

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[324] Gordon (1987) *N Y U LR* 94.

[325] 94-95.

[326] See S 76(4)(a) of the Companies Act.

[327] LD Weinberger "The business judgment rule and sphere sovereignty" (2010) 27 *T M Cooley LR* 279 292 footnote 73.

shareholders since well-chosen risks regularly generate greater returns.[328] Thus, from a shareholder's perspective, it makes sense to protect corporate management from liability where they have made a business decision that rationally (but wrongly) assessed the risks and rewards, but the decision turned out to be the wrong one.[329]

On the other hand, a rule that encourages a high degree of risk-taking would not serve trust beneficiaries.[330] A comparison of the parties to be protected – shareholders and trust beneficiaries – shows that the parties have very different expectations regarding risk. First, shareholders can hold diversified portfolios of investments to reduce the risk of being exposed to any particular investment.[331] Gordon explains that the situation of a typical beneficiary is quite different from that of a shareholder:[332]

> "The typical beneficiary may have a large portion of his wealth tied up in the trust. If so, he will be unable to diversify against a trust portfolio that is exposed to a high degree of risk. No matter how wisely the trustee has selected the risks, such a beneficiary will regard the portfolio as too risky for his interests."

Second, shareholders can monitor the performance of directors and dispose of those directors whose performance is substandard, or shareholders can simply sell off their shareholding. In contrast, beneficiaries do not normally select trustees, and the settlor who had selected the trustees, has likely passed away. Furthermore, even if the beneficiaries have sufficient financial sophistication to identify poor risk-taking, they may find it onerous to remove the trustees.[333]

Risk-averse beneficiaries would rather prefer a duty that counsels caution than a rule that counsels business risk-taking. Appropriately, both the prudent investor rule of the Restatement (Third) and New York's prudent investor rule impose a duty of caution on trustees. The duty of caution requires trustees to assure an appropriate risk level in light of the needs of the trust.[334]

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[328] Gordon (1987) *N Y U LR* 95.

[329] Sitkoff (2004) *Cornell LR* 656-657; MB Leslie "Trusting trustees: fiduciary duties and the limits of default rules" (2005) 94 *Georgetown LJ* 67 98.

[330] Leslie (2005) *Georgetown LJ* 99.

[331] Weinberger (2010) *T M Cooley LR* 291.

[332] Gordon (1987) *N Y U LR* 95-96.

[333] 95

[334] Gordon (1987) *N Y U LR* 95; Sitkoff (2004) *Cornell LR* 655-356.

7 Conclusion

The prudent man rule derives from the *Amory* case. In 1830, the Supreme Judicial Court of Massachusetts rejected the English rule requiring investment in government securities only. The original formulation of the rule, the traditional prudent man rule, is a model of flexibility. The rule was adopted in New York up until 1869.

In 1869, *Talbot* dramatically narrowed the traditional prudent man rule. The New York State Court of Appeals restricted trustees' choice of investments to government bonds and mortgages, and proscribed investment in corporate stocks. The decision in *Talbot* led to the passage of a New York statute in 1889 governing permissible trust investments. This marked the beginning of so-called legal lists.

The break from legal lists came in 1970 when New York adopted its own version of the prudent man rule – referred to in this chapter as New York's prudent man rule. New York's prudent man rule closely resembled Scott's prudent man rule. Gordon refers to Scott's rule as the constrained prudent man rule. The principal problem with the constrained prudent man rule was that it could not adapt to general circumstances. In other words, the rule was not capable of adapting to changing times (eg rising inflation) and changing notions of investment opportunity and risk-taking (eg the findings of MPT).

MPT makes it possible for trustees to earn the maximum possible return for a chosen level of portfolio risk. Since the constrained prudent man rule discouraged trustees from adopting generally accepted MPT strategies, beneficiaries were denied effective investment management. Stated in simple terms, the rule deterred trustees from doing the best possible job they were capable of doing for beneficiaries. Consequently, the constrained prudent man rule, as well as New York's prudent man rule, prevented trustees from acting prudently.

Reform did not come through a series of court cases. Rather, the criticism from authors such as Langbein and Posner, Fleming, Longstreth, and Gordon set the stage for the evolution from the prudent man rule to the prudent investor rule. The critics argued that those aspects of Scott's prudent man rule (the constrained prudent man rule) that discouraged trustees from adopting generally accepted MPT strategies needed to be reformed and updated, and that the focus of trustees' investment policies should not be on the avoidance of risk but on the prudent management of risk.

Following the criticism of Scott's prudent man rule, the American Law Institute embraced MPT by promulgating the prudent investor rule of the Restatement (Third). Shortly thereafter, the New York State Legislature enacted the Prudent Investor Act on 31 December 1994. Based on the Restatement (Third), the Act includes the major principles of MPT. New York codified its own version of the prudent investor rule (New York's prudent investor rule) and in doing so, replaced New York's prudent man rule.

The Prudent Investor Act made five important changes to existing law: first, New York's prudent investor rule applies to the entire portfolio rather than to a particular investment viewed in isolation; second, the rule authorises trustees to invest in any type of investment since no particular investment is prudent or imprudent *per se*; third, the Act imposes on trustees a duty to diversify trust assets; fourth, New York's prudent investor rule requires trustees to consider the expected total return of a trust portfolio; and fifth, the rule permits trustees to delegate investment and management functions in certain instances. It should also be noted that the Act does not abolish the anti-netting rule.

The following are some of the key features of New York's prudent investor rule: first, the rule transforms the role of a trustee from a wealth conservator (who avoids risk) to a wealth manager (who consciously assumes and manages risk). This transformation is important because trusts differ considerably in their risk-bearing capacities. Low levels of risk may be appropriate in some trust settings but inappropriate in others. Second, the rule includes a duty to be cost conscious in investing. Trustees should thus incur costs only to the extent that the costs are appropriate and reasonable in relation to the purposes of the governing instrument, the assets held by the trustee and the skills of the trustee. Third, the rule does not impose an affirmative duty on trustees to invest with a view to protect against inflation. Rather, because of the duty of caution, trustees must consider the objective of the particular trust and then use their best judgement to decide whether the objective of the trust constitutes the preservation of the trust estate in nominal or real terms. However, considering that the new role of a trustee is that of wealth manager, the expectation is that a court will justify an investment strategy only aimed at preserving the estate in nominal terms in very few circumstances.

The next chapter examines the development of trustees' investment standards in England. The chapter will show that England has also advanced beyond primordial doctrines regarding trustee investment and has integrated MPT principles into trust law.

CHAPTER 5 – THE DEVELOPMENT OF TRUSTEES' INVESTMENT STANDARDS IN ENGLAND

1 Introduction

This chapter describes and analyses the development of trustees' investment standards in England. The theoretical underpinnings of trustees' investment standards over the centuries can be reduced to two doctrines – the "authorised list principle"[1] and the "prudent man standard".[2] The English Law Commission and the Scottish Law Commission (hereafter referred to as the "two Law Commissions") illustrated in their joint 1999 report (hereafter referred to as the "joint Law Commissions' report") that the authorised list principle was out of step with modern thinking.[3] Furthermore, according to Moffat, the prudent man standard as traditionally understood was incompatible with modern portfolio theory ("MPT") in some respects.[4]

The enactment of the Trustee Act 2000 led to extensive reform of the law of trust investment. Most notably, it did away with the authorised list principle. Further examination of the position after 2000 indicates that most of the changes that the Act made are consistent with the tenets of MPT.

The purpose of the chapter is to provide answers to four important questions: first, why was it necessary to replace the authorised list principle with wider powers of investment? Second, what was the standard of care required of trustees under the prudent man standard in the case of powers of investment? Third, from an investment perspective, what are the main features of the Trustee Act 2000? Fourth, how has trust investment law changed in England after 2000? In answering these questions, the chapter illustrates the problem with being restricted to an authorised list of investments; the difficulties trustees face when trustee investment standards do not take MPT into account; how English law balances wider powers of investment with appropriate safeguards; and what obstacles had to be eliminated in order to implement MPT.

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[1] See para 2 1 below.

[2] See para 2 2 below.

[3] See para 3 1 below.

[4] See para 5 below.

Following this introduction, the chapter is divided into four sections, which are summarised in the conclusion at the end of the chapter. Section 2 discusses the origin of the authorised list of investments, what the initial acceptable securities were, and how the range of acceptable securities was extended over time. Following this discussion, the section describes what was expected from trustees under the prudent man standard – both in general trust administration and when making investments. Section 3 explores the background to the Trustee Act 2000. More specifically, the section investigates the development of trustees' investment standards in the 40-year period before the Act came into force. The first part of the section explains why there was a demand for reform in the 1960s and discusses the purpose, central features and criticisms of the Trustee Investments Act 1961. The second part of the section explains how the traditional investment policy of avoiding all investments of a hazardous nature was modified in the 1980s. Section 4 discusses trustees' power of investment under the Trustee Act 2000 and the safeguards put in place to protect the interests of trust beneficiaries. Section 5 examines trust investment law before and after 2000 in order to determine the obstacles to implementing MPT, to determine which of these obstacles were removed, and to establish how they were removed.

2 The early development of trust investment law

2 1 The statutory legal list of authorised investments

The English fiduciary doctrine for trust fund investment begins with the South Sea "Bubble" of 1720.[5] In 1719, the British Parliament authorised trustees to invest in the shares of the South Sea Company.[6] The South Sea Bubble burst the following year and share prices declined by 90%. Public confidence in company stock was destroyed.[7] Investments that were lost included the funds of many trust beneficiaries.[8]

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[5] D Grosh "Trustee investment: English law and the American prudent man rule" (1974) 23 *Int'l & Comp LQ* 748 751.

[6] JH Langbein "The Uniform Prudent Investor Act and the future of trust investing" (1996) 81 *Iowa LR* 641 643.

[7] JH Langbein & RA Posner "Market funds and trust-investment law" (1976) 1 *Am B Found Res J* 1 3.

[8] Ontario Law Reform Commission *Report on the Law of Trusts* (1984) Volume 1 190.

In response to the collapse of the South Sea Company, the English Court of Chancery developed a court-made list of investments that were presumptively proper for trustees.[9] Originally, trustees were limited to Bank of England consolidated bank annuities (also known as "consols").[10] This was unless the trustees were specifically authorised by the trust instrument to invest beyond the court-made list.[11]

The range of acceptable securities broadened as a result of statutory changes in the mid-nineteenth century. The first statutory legal list of authorised investments appeared in what was known as Lord St Leonard's Act, passed in 1859.[12] The list permitted investment in stock of the Bank of England and the Bank of Ireland, the highly successful East India Company, and mortgages of real property in England, Ireland, and Wales.[13] In later years, the list underwent further change. Successive statutes between 1859 and 1925 added various local and colonial government issues, and certain railway debentures were added in 1889.[14] The securities of the statutory legal list were all of the same type: fixed-income securities.[15] During that period, corporate stock was not considered good security for trustee investing:[16]

> "Throughout the eighteenth and nineteenth centuries, court and Parliament alike considered equity stock to be too speculative and too risky for trustee investment."

The Trustee Act 1925 consolidated the statutory legal list but did not extend it.[17] The inclusion of corporate stock in the Act was considered, but was rejected in favour of the established policy of permitting only fixed-income securities.[18] Trustees

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[9] Langbein & Posner (1976) *Am B Found Res J* 3; MM Schanzenbach & RH Sitkoff "The prudent investor rule and trust asset allocation: an empirical analysis" (2009) 35 *ACTEC J* 314 317.

[10] Grosh (1974) *Int'l & Comp LQ* 751; P Panico "Trustees investment powers in international trust law" (2009) 15 *T & T* 96 97.

[11] Grosh (1974) *Int'l & Comp LQ* 751.

[12] Ontario Law Reform Commission *Report on the Law of Trusts* 191.

[13] Langbein & Posner (1976) *Am B Found Res J* 3; A Duckworth "Legal aspects of trustee investment – is the prudent man still alive and well? Part 1" (1997) *PCB* 22 23-24; Grosh (1974) *Int'l & Comp LQ* 751.

[14] J Mowbray, L Tucker, N le Poidevin, E Simpson & J Brightwell *Lewin on Trusts* 18 ed (2008) 1270; Langbein & Posner (1976) *Am B Found Res J* 3-4.

[15] Duckworth (1997) *PCB* 24; Grosh (1974) *Int'l & Comp LQ* 751.

[16] Grosh (1974) *Int'l & Comp LQ* 751.

[17] 751

[18] Ontario Law Reform Commission *Report on the Law of Trusts* 192.

without a wide express power of investment were therefore still limited only to narrow categories of investment.[19]

2 2 Trustees' duty of care at common law

The law describing trustees' duty of care derives from the case of *Speight v Gaunt*[20] ("*Speight*").[21] Isaac Gaunt was the trustee of a testamentary trust, which was set up in the will of a textiles manufacturer named John Speight. Gaunt, also a local textiles manufacturer, had no professional investment expertise but accepted trusteeship out of friendship with Speight. Gaunt employed a stockbroker, John Cooke, to invest the bulk of the assets of the trust fund in the purchase of corporation bonds. Cooke presented Gaunt with a forged bought note as evidence that he had procured the securities. Gaunt paid the money over to Cooke without enquiring why no account date appeared on the note. Cooke, being nearly insolvent, promptly applied the money to his debts and vanished.[22]

The beneficiaries of the trust sued Gaunt for failing in his duty of care as trustee. They alleged imprudence on his part in "choosing and trusting a dishonest agent, and failing to enquire into the veracity of the bought note before tendering payment".[23] Bacon VC in the Court of Chancery found Gaunt liable and ordered him to make good the loss of £15 275. Gaunt appealed from the decision of the Court of Chancery. The Court of Appeal was not persuaded by the Vice-Chancellor and reversed the decision in Gaunt's favour.[24] Jessel MR held that, because the trustee acted in the ordinary course of business, he was not liable to make good the loss occasioned by the misappropriation of the trust fund by Cooke. The key part of his judgment stated as follows:[25]

> "... what is the liability of a trustee who undertakes an office which requires him to make an investment on behalf of his *cestui que trust*? It seems to me that on general principles

[19] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* (1999) Law Com No 260 and Scot Law Com No 172 13.

[20] (1883) 9 App Cas 1 (HL).

[21] J Getzler "Duty of care" in P Birks & A Pretto (eds) *Breach of Trust* (2002) 41 41.

[22] 62.

[23] 62.

[24] 63.

[25] 63-64.

> a trustee ought to conduct the business of the trust in the same manner that an ordinary prudent man of business would conduct his own, and beyond that there is no liability or obligation on the trustee. In other words, a trustee is not bound because he is a trustee to conduct business in other than the ordinary and usual way in which similar business is conducted by mankind in transactions of their own. It never could be reasonable to make a trustee adopt further and better precaution than an ordinary prudent man of business would adopt, or to conduct the business in any other way. If it were otherwise, no one would be trustee at all."

Lindley LJ and Bowen LJ gave concurring judgments,[26] and the House of Lords upheld the decision of the Court of Appeal.[27]

Oakley refers to the standard laid down in *Speight* as the "normal common law duty",[28] and Moffat refers to it as the "common law position" or the "prudent person of business standard".[29] Getzler describes the standard as follows:[30]

> "... trustees are to be held to the standard that an ordinary prudent man would follow in running his own business."

Hereafter the standard is referred to as the "prudent man standard".[31]

2 3 Modification of the prudent man standard in the case of powers of investment

In *Learoyd*, the prudent man standard was modified in the case of powers of investment.[32] Benjamin Whiteley, by his will in 1874, appointed Learoyd (an accountant) and Carter (a schoolmaster) as his executors and trustees. Whiteley died in 1876. In his will, he directed the trustees to invest £5 000 and pay the income to Elizabeth Whiteley during her life, and to hold the investments in trust for her children after her death. The investment clause in the will contained a power to invest "in or upon real securities in England or Wales". The trustees invested £3 000

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[26] 41.

[27] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 15 footnote 20; RP Pearce & J Stevens *The Law of Trusts and Equitable Obligations* 4 ed (2006) 621.

[28] AJ Oakley *Parker & Mellows: The Modern Law of Trusts* 8 ed (2003) 592.

[29] G Moffat *Trust Law Text and Materials* 5 ed (2009) 464.

[30] Getzler "Duty of care" in Birks & Pretto *Breach of Trust* 41.

[31] LOC Chukwu "Theoretical underpinnings of trust investment law: juxtaposing Nigerian law with current trends in other Common Law jurisdictions" (2017) 22 *Ann Surv Int'l & Comp L* 73 74.

[32] Oakley *Modern Law of Trusts* 592.

in a mortgage of a brickfield, and the remaining £2 000 in mortgages of four small houses.[33] Later, the mortgagors of the brickworks went bankrupt. As regards to the mortgages on the houses, the mortgagor never paid any interest on the £2 000. He filed a petition for liquidation in 1879.[34]

The action was brought by Elizabeth Whiteley and her children ("the beneficiaries") against the executors and trustees of the estate of Benjamin Whiteley. The beneficiaries sought to make the trustees answerable for the loss of the legacy of £5 000, which, it was alleged, had been invested by them in insufficient securities.[35] Bacon VC held in the Chancery Court that the brickfield investment was unauthorised and the trustees were responsible for its failure. As regards to the mortgages on the houses, Bacon VC held that the trustees were not responsible for the insufficiency of that investment. The trustees appealed from this judgment so far as related to the mortgage of the brickfield, and the beneficiaries gave cross notice of appeal from the judgment so far as related to the mortgage of the houses.[36]

The appeal regarding the houses was dismissed.[37] The first question on appeal regarding the brickfield investment was whether the investment was an authorised investment. In other words, was the investment within the terms of the trust in fact a real security?[38] Assuming the investment to be technically a real security, the second question was whether it was a proper real security. That is, whether it was such an investment as an ordinary prudent man of business would select if he was acting for himself and others.[39]

The Court of Appeal affirmed Bacon VC's decision that the trustees were liable for repayment of the £3 000 invested in the brickfield.[40] Lopes LJ considered the investment to be technically a real security. He stated that:[41]

> "... if only £500 had been advanced, no objection could have been taken to the character of the investment".

[33] *In Re Whiteley, Whiteley v Learoyd* (1886) 32 Ch. D. 196 196-197.
[34] 197.
[35] *In Re Whiteley, Whiteley v Learoyd* (1886) 33 Ch. D. 347 347.
[36] 348.
[37] 357-358.
[38] 359.
[39] 356 and 358.
[40] *Learoyd v Whiteley* (1887) 12 App. Cas. 727 729.
[41] *In Re Whiteley, Whiteley v Learoyd* (1886) 33 Ch. D. 347 359.

However, regarding the question whether the investment was a *proper* real security, he was of the opinion that the investment did not answer that description. Lopes LJ explained that the value of the piece of land by itself, being a brickfield, was not worth more than £1 500. Any value beyond that sum was attributable to the plant and machinery, and more especially to the trade to be carried on upon the land. He further regarded the investment as having a hazardous nature:[42]

> "[The investment's] value mainly depends on the success of a speculative and fluctuating business, a business for which it is difficult to find customers, a business largely dependent on the energy and solvency of those working it, a business of necessity of precarious duration, which cannot be carried on without such an excavation and destruction of the soil as must eventually leave what remains nearly useless for agricultural and other purposes."

Lopes concluded that no prudent man investing money for the benefit of himself and others would have invested so large a sum as £3 000 upon such a hazardous security.[43] Therefore, although the will authorised the trustees to invest beyond the statutory legal list, they were still under a general duty to use care and skill[44] in investing trust funds.[45] Cotton LJ and Lindley LJ gave concurring judgments,[46] and the House of Lords confirmed the Court of Appeal's decision that the trustees invested the trust fund in a very insufficient security.[47]

An especially significant point to be taken from *Learoyd* is the fact that it was found that trustees were required to exercise caution in investing. When *Speight* came before the House of Lords, Lord Blackburn held that the general duty of trustees was to act honestly and fairly and to "take all those precautions which an ordinary prudent man of business would take in managing similar affairs of his

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[42] 359.

[43] 357.

[44] The language used by Chancery judges tended to focus on the concept of prudence, the term used in *Learoyd*. In contrast, the common law usually uses the composite phrase "care and skill". According to Halpern, this difference in terminology tends to obscure the fact that, at a high level of abstraction, the same moral imperative underpins both concepts: D Halpern "Negligent investment: claims against trustees and agents" (2009) 15 *T & T* 602 603.

[45] Grosh (1974) *Int'l & Comp LQ* 753; Duckworth (1997) *PCB* 24.

[46] *In Re Whiteley, Whiteley v Learoyd* (1886) 33 Ch. D. 347 355 and 358.

[47] *Learoyd v Whiteley* (1887) 12 App. Cas. 727 727-728.

own".[48] In *Learoyd*, Lindley LJ refined this *dictum* when it comes to making investments.[49] He stated that:[50]

> "The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide."

This was because:[51]

> "[b]usiness men of ordinary prudence may, and frequently do, select investments which are more or less of a speculative character; but it is the duty of a trustee to confine himself to the class of investments which are permitted by the trust, and likewise to avoid all investments of that class which are attended with hazard".

In other words, whereas individual investors could be as reckless or as careful as they please in selecting their own investments, trustees always had to adopt a more cautious investment policy.[52]

3 Background to the Trustee Act 2000

3 1 The criticism of two Law Commissions of the Trustee Investments Act 1961

The weakness of the legal list philosophy began to emerge in the 1930s.[53] Several factors appeared that contributed to the disenchantment with fixed-income securities. These were post-war inflation, the devaluation of the pound sterling, rising taxes, the nationalisation of major industries, and the increasing sophistication and

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[48] Pearce & Stevens *Trusts and Equitable Obligations* 621.

[49] D Hayton "English fiduciary standards and trust law" (1999) 32 *Vand J Transnat'l L* 555 556; T Molloy "I am a trustee. I can't make head or tail of (algorithm). Am I at risk?" (2009) 15 *T & T* 524 534.

[50] *In Re Whiteley, Whiteley v Learoyd* (1886) 33 Ch. D. 347 355.

[51] *Learoyd v Whiteley* (1887) 12 App. Cas. 727 733; Oakley *Modern Law of Trusts* 592; Panico (2009) *T & T* 97.

[52] Moffat *Trust Law* 467.

[53] Ontario Law Reform Commission *Report on the Law of Trusts* 192.

expansion of investment markets throughout the world.[54] However, the most important factor was inflation.[55]

In the commercial recovery after two successive world wars in the 1950s, it was corporate stock that provided the best hedge against inflation.[56] Throughout most of the twentieth century, trusts that were restricted to the statutory legal list tended to underperform compared with trusts that invested in the security market.[57] Most well-advised settlors "contracted out" of conservative investment limitations by conferring upon their trustees considerably greater investment freedom than was authorised by the Trustee Act 1925.[58]

Consequently, as a result of several studies, debates, and requests for reform, the Trustee Investments Act 1961 received royal assent on 3 August 1961.[59] The purpose of the Act was to allow trustees to "invest in assets with a greater potential for return, in particular in shares, without taking an undue risk with the trust capital".[60] The Act made three changes to trustee investment: first, it imposed on trustees a limited statutory duty to obtain and consider advice about whether an investment is satisfactory.[61] Second, it required trustees to have regard to the need for diversification of investments so far as appropriate to the circumstances of the trust.[62] Third, it provided for the division of the trust fund into two parts, known as the narrower-range and wider-range parts. The narrower-range part was available for investment in narrower-range investments and the wider-range part was available for investment in narrower-range or wider-range investments.[63] Originally these parts had to be of equal value, but the proportion of the wider-range part was increased to three-quarters in 1996.[64] Narrower-range investments were restricted to fixed-

[54] 192; Grosh (1974) *Int'l & Comp LQ* 752; Mowbray et al *Lewin on Trusts* 1272.

[55] Grosh (1974) *Int'l & Comp LQ* 752.

[56] Ontario Law Reform Commission *Report on the Law of Trusts* 192-193.

[57] 193; Getzler "Duty of care" in Birks & Pretto *Breach of Trust* 70.

[58] Getzler "Duty of care" in Birks & Pretto *Breach of Trust* 70.

[59] Ontario Law Reform Commission *Report on the Law of Trusts* 93; The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 31 footnote 107.

[60] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 13.

[61] 14.

[62] Mowbray et al *Lewin on Trusts* 1271.

[63] 1271; The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 13-14.

[64] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 18; Oakley *Modern Law of Trusts* 597 footnote 37.

income securities, including investment in mortgages of land and a diverse range of bonds, debentures and the like.[65] Wider-range investments consisted mainly of shares (subject to a number of restrictions) and authorised unit trusts.[66]

When the Trustee Investments Act 1961 was enacted, it was well-known that investing in shares carried a degree of risk of capital loss and that this type of risk was not present with assets such as fixed-income securities. It was for this reason that Parliament considered it appropriate, in the absence of express powers, to ensure that trusts contained a core of investments in fixed-income securities.[67]

The two Law Commissions accepted that the Act was a significant step forward. The Act did, for example, give trustees wider default powers of investment than they had previously enjoyed. However, the two Law Commissions found that the provisions of the Act operated in a way that was not only needlessly restrictive, but was also positively detrimental to most trusts to which it applied.[68] First, the need to conform with the requirements of the Act, especially the requirement to divide the trust fund, was administratively burdensome and increased administrative costs. Second, the definition of wider-range investments was quite restrictive. It did not include investments in the purchase of land and permitted trustees to invest only in shares that meet certain qualifying conditions.[69] For example, a company had to have paid regular dividends on all of its shares.[70] A practical result of the requirement to meet certain conditions was that trustees could not invest in many well-known public companies:[71]

> "... in the 1980s and 1990s, many prudent investors were purchasing shares in denationalized utilities, trustees were unable to do so, because the new public limited companies (such as British Gas plc and British Telecom plc) had no track record and therefore failed to meet the stringent criteria laid down by the Trustee Investments Act 1961 for investment in quoted companies."

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[65] Grosh (1974) *Int'l & Comp LQ* 752; Mowbray et al *Lewin on Trusts* Lewin 1271.

[66] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 13-14; De Waal (1999) *TSAR* 377.

[67] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 13-14; Ontario Law Reform Commission *Report on the Law of Trusts* 192-193.

[68] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 16.

[69] 16-17.

[70] Grosh (1974) *Int'l & Comp LQ* 761.

[71] G Watt *Trusts and Equity* 4 ed (2008) 411-412.

Third, the frequent exclusion of the provisions of the Act in trust instruments meant that its application became more the exception than the rule. Most trusts usually conferred wide investment discretion on the trustees. Evidence submitted to the Law Reform Committee suggested that the provisions of the Act most commonly applied in practice only to older trusts, trusts made without professional advice, and statutory trusts that arose on intestacy.[72]

Consequently, the two Law Commissions recommended reform that would lessen the administrative burden and associated costs of the Trustee Investments Act 1961 and facilitate the use of modern investment services in trusts.[73]

3 2 Modification of the traditional investment policy of avoiding all investments of a hazardous nature

Hudson states that in *Bartlett v Barclays Bank Trust*[74] ("*Bartlett*"), Brightman J modified the old approach found in *Learoyd*.[75] The material facts of the case were as follows: a trust corporation, Barclays Bank Trust, was the sole trustee of the Bartlett trust, set up by Sir Herbert Bartlett in 1920.[76] The sole asset of the trust was 99.8% of the issued shares in a private company.[77] There were two directors – an accountant and a solicitor – on the board of directors; no member of the Bartlett family was on the board.[78]

In 1961, the board announced their plans to change the company's policy of investment. The board wanted to expand the company's business from managing property to also developing property. The trustee, through one of its trust managers, agreed to this policy on condition that the income available to the beneficiaries was not affected.[79] Accordingly, the "main objects clause" of the company was redefined at the annual general board meeting to allow for the development of property.[80]

[72] Moffat *Trust Law* 477 and 501.

[73] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* iii.

[74] (1980) 2 W.L.R. 430.

[75] A Hudson *Equity and Trusts* 8 ed (2015) 446-447.

[76] *Bartlett v Barclays Bank Trust* (1980) 2 W.L.R. 430 434.

[77] CJ Virgo & EH Burn *Maudsley and Burn's Trusts and Trustees* 6 ed (2002) 751.

[78] *Bartlett v Barclays Bank Trust* (1980) 2 W.L.R. 430 430.

[79] 434-435.

[80] 430.

From 1961 until 1973, the board embarked on speculative development in property; the trustee neither being consulted nor requiring to be consulted. The primary development scheme became known as the Old Bailey project.[81] The project ended in disaster when planning permission could not be obtained for the development and the trust suffered a significant loss.[82] By "loss", the following is meant:[83]

> "... the depreciation which took place in the market value of the BT [the company] shares, by comparison with the value which the shares would have commanded if the loss on the Old Bailey project had not been incurred, and reduction of dividends through loss of income."

The plaintiffs, being the grandchildren of Sir Herbert Bartlett, claimed that the defendant trustee was liable to make good to the trust fund the loss accruing by reason of it having permitted the company to engage in property development.[84] Brightman J found that the Old Bailey project was "imprudent and hazardous and wholly unsuitable for a trust whether undertaken by the trustee direct or through the medium of its wholly owned company",[85] and allowed the claim.[86] Brightman J held that the trustee had not discharged its duty as trustee in that it failed to supervise the new ventures of the company. It was not sufficient for the trustee to have relied merely on the supply of information that it received in the ordinary course as a shareholder.[87] The trustee, being a majority shareholder, should have "required the board to inform and consult it so that it could intervene if necessary to safeguard the interest of the trust."[88]

Under the old authority of *Learoyd*, when a trustee is investing trust property, he must not only act as a business man of ordinary prudence, but he must also avoid all

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[81] 430-431.
[82] 437.
[83] 444.
[84] 438.
[85] 444.
[86] 431.
[87] 444.
[88] 431.

investments of a hazardous nature.[89] The difficulty with this approach is that all investments necessarily involve some risk and it is thus impossible for trustees to make investments that are entirely risk-free.[90] As Molloy states it:[91]

> "Life presents many dangers. Not the least of them is safety. As the faithless servant in Matthew's Parable of the Talents discovered, totally risk-free investment is an oxymoron. Not even burying the trust estate affords protection against loss..."

So, Brightman J modified the approach slightly by drawing a distinction between a prudent degree of risk on the one hand and a hazard on the other.[92] The former, a prudent degree of risk, would be acceptable, whereas the latter, to put the trust in hazard, would be unacceptable.[93] According to Moffat, where the balance lies between "prudence" and "hazard" depends on the characteristics of the trust fund.[94]

4 The Trustee Act 2000

The Trustee Act 2000 Act came into force on 1 February 2001.[95] In response to the criticisms of the Trustee Investments Act 1961, section 3 of the Trustee Act 2000 confers the widest possible investment powers on trustees:[96]

> "... a trustee may make any kind of investment that he could make if he were absolutely entitled to the assets of the trust."

The Act refers to the power under section 3 as the "the general power of investment".[97] The general power of investment is a default power and is thus subject to any restriction or exclusion imposed by the trust instrument.[98] According to Reed and Wilson, the fact that a trustee can only make such investments as he

[89] *Learoyd v Whiteley* (1887) 12 App. Cas. 727 733; Molloy (2009) *T & T* 534; Chukwu (2017) *Ann Surv Int'l & Comp L* 83.

[90] Hudson *Equity and Trusts* 446.

[91] Molloy (2009) *T & T* 535.

[92] *Bartlett v Barclays Bank Trust* (1980) 2 W.L.R. 430 441.

[93] Hudson *Equity and Trusts* 447.

[94] Moffat *Trust Law* 483.

[95] Mowbray et al *Lewin on Trusts* 1023.

[96] S 3(1) of the Trustee Act 2000.

[97] S 3(2). The general power of investment is not available to the trustees of pension funds, authorised unit trusts or certain charity funds: Mowbray et al *Lewin on Trusts* 1257.

[98] S 6(1) of the Trustee Act 2000.

could if the assets belonged to him, makes little difference in practice. They mention that one exception might be the case of a corporate trustee with restricted powers of dealing with its own assets.[99]

4 1 Balancing the introduction of wider powers of investment with appropriate safeguards

4 1 1 General duties applicable to trustees

The two Law Commissions proposed that safeguards for the protection of beneficiaries should balance the introduction of wider statutory powers of investment.[100] The two Law Commissions accepted that the proposals for wider powers of investment did not affect the general duties that the law imposes on trustees. Therefore, trustees must continue to act in the best interests of the beneficiaries and must avoid any conflict between their duties as trustees and their own personal interests.[101] They must also act impartially; hence they must seek to strike a balance, so far as is possible, between the competing interests of income and capital beneficiaries. The two Law Commissions also considered that trustees must be subject to a statutory duty of care when exercising their powers of investment.[102] The latter duty, the statutory duty of care, requires explaining.

Section 1 of the Trustee Act 2000 introduces a new statutory duty of care:[103]

> "Whenever the duty under this subsection applies to a trustee, he must exercise such care and skill as is reasonable in the circumstances ..."

A further reading of section 1 reveals that the statutory duty of care, whilst creating an objective standard of care, does have a subjective element to it. In other words, the standard is variable according to the subjective characteristics of the trustees. According to Chukwu, the subjective characteristics of a trustee should be considered only in order to "raise, but never to lower, the bar".[104] Factors that might lead to a stricter standard would include: where a trustee is acting in a professional

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[99] PJ Reed & RC Wilson *The Trustee Act 2000 – A Practical Guide* (2001) *39*.

[100] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 22.

[101] 33.

[102] Moffat *Trust Law* 492.

[103] S 1(1) of the Trustee Act 2000.

[104] Chukwu (2017) *Ann Surv Int'l & Comp* 86.

capacity; or where an individual trustee claims to have special knowledge or experience and skill.[105] In *Bartlett*, Brightman J expressed the view that professional trustees have a higher standard of care than ordinary prudent men or women. Therefore, a trust corporation is expected to exercise the care of a specialist in trust administration, reflecting the fact that it holds itself out as having such specialist skill. In *Bartlett*, the court found that the bank trustee failed in its duty whether judged by the standard of the prudent man of business or by the standard of the skilled trust corporation.[106]

Schedule 1 to the Trustee Act 2000 outlines the situations in which the statutory duty of care applies.[107] Of importance here is the fact that it applies to trustees when "exercising any power of investment". It is also worth mentioning the other situations in which the statutory duty of care applies. It applies to trustees when exercising any power in relation to land; entering into arrangements under which a person is authorised to exercise functions as an agent, nominee or custodian; exercising any power of compromise; exercising the power to insure property; and exercising the power to do valuations.[108]

Since the statutory duty of care is not of general application, the prudent man standard continues to apply to certain other duties and powers.[109] The prudent man standard broadly continues to apply in relation to the duties of trustees concerning custody of the trust property and its management;[110] dispositive powers of trustees such as discretion to select from a class of beneficiaries;[111] and where trustees are exercising a power under a trust instrument to carry on a business.[112]

4 1 2 Specific duties applicable to trustees

In addition to the three general duties – the duty to act in the best interests of beneficiaries, the duty to act impartially, and the statutory duty of care – the Trustee Act 2000 imposes two specific duties on trustees in the performance of their

[105] S 1(1) of the Trustee Act 2000; Pearce & Stevens *Trusts and Equitable Obligations* 621.
[106] *Bartlett v Barclays Bank Trust* (1980) 2 W.L.R. 430 443-444; Duckworth (1997) *PCB* 33.
[107] S 2 of the Trustee Act 2000.
[108] Schedule 1 to the Trustee Act 2000; Moffat *Trust Law* 463.
[109] Moffat *Trust Law* 465; Mowbray et al *Lewin on Trusts* 1213.
[110] Mowbray et al *Lewin on Trusts* 1215.
[111] Moffat *Trust Law* 463.
[112] 465-466; Virgo & Burn *Trusts and Trustees* 683 footnote 8.

investment functions: first, trustees must have regard to what is termed the standard investment criteria and, second, they are under a duty to obtain and consider advice.

4 1 2 1 The standard investment criteria

The Trustee Act 2000 requires trustees exercising a power of investment to have regard to what is described as the standard investment criteria.[113] These criteria are not new; they first appeared in the Trustee Investments Act 1961.[114] There are two such criteria: first, trustees must have regard to the suitability of the investment concerned and, second, to the need for diversification.[115] Trustees must have regard to these standard investment criteria both in making investments and also in periodically reviewing the investments.[116] The provision to keep the investments of the trust under review is in effect a codification of the common law position.[117]

The suitability requirement means that it is the duty of the trustees to consider whether a particular investment is appropriate for the trust in question.[118] From the Explanatory Notes that accompany the Trustee Act 2000, it appears that the size of the investment; the risk of the investment; the need to produce an appropriate balance between income and capital growth; and "ethical considerations" are relevant in judging whether the investment is suitable.[119] Hudson explains the second consideration, the risk of the investment, as follows:[120]

> "Where the trust is a small family trust with a comparatively weak risk appetite, the investments to be made should be safe, whereas investments made on behalf of a trust fund created by two corporations who are expert in financial services ... could be considerably more adventurous, and so intended to take greater risks."

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[113] S 4(1) of the Trustee Act 2000.

[114] Pearce & Stevens *Trusts and Equitable Obligations* 622 footnote 81.

[115] SR Chowdhury "Whether or not the law relating to modern trustees' power and duties have achieved a balance between managing the trust assets and protecting the interest of the beneficiaries: a critical analysis" (2015) 6 *Mediterr J Soc Sci* 386 388.

[116] S 4(2) of the Trustee Act 2000.

[117] Moffat *Trust Law* 493.

[118] Chowdhury (2015) *Mediterr J Soc Sci* 388.

[119] Note 23 of the Explanatory Notes accompanying the Trustee Act 2000.

[120] Hudson *Equity and Trusts* 439. See also Hudson's comparison of a trust created by a billionaire and a trust created for an elderly widow: 436-437.

Other factors that might be taken into account when looking at the issue of suitability are considerations as to the expected duration of the trust; the beneficiaries' tax position;[121] and the probable timing of distribution of income or capital to specific beneficiaries.[122]

The second criteria requires trustees to pay heed to "the need for diversification of investments of the trust, in so far as is appropriate to the circumstances of the trust".[123] Strictly speaking, trustees are not obliged to diversify but they are duty-bound to consider diversification. Nevertheless, if the trust fund is substantial and the power of investment is unrestricted, the trustees would need good reason not to diversify. As Le Poidevin states it:[124]

> "... a trustee would need to have some good reason for putting all its eggs in one basket."

Diversification is not defined in the Trustee Act 2000, but it means maintaining a good spread of investments.[125] The rule speaks of diversification as a need; it is needed in order to reduce risk.[126] By holding a combination of assets, known as a portfolio, trustees are able to minimise the risk to which the trust fund is exposed. Some combinations of assets will be more effective than others in reducing the overall risk on the portfolio. Take the following simplified example:[127]

> "... if two assets are likely to perform well under opposite market conditions or at different times, then dividing the fund between these two would substantially reduce the degree of risk; on the other hand, dividing the fund between two investments which will tend to track each other and perform well under similar conditions would be less effective at reducing overall risk."

Therefore, in order to reduce risk, it is more effective to choose investments that have offsetting risks.[128]

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[121] Moffat *Trust Law* 493.

[122] 493; Reed & Wilson *Trustee Act 2000* 43.

[123] S 4(3)(b) of the Trustee Act 2000.

[124] N le Poidevin "The worried trustee" (2009) 15 *T & T* 596 600.

[125] Mowbray et al *Lewin on Trusts* 1286; Reed & Wilson *Trustee Act 2000* 44.

[126] Oakley *Modern Law of Trusts* 604.

[127] R Thornton "Ethical investments: a case of disjointed thinking" (2008) 67 *Cambridge LJ* 396 400.

[128] JE Penner *The Law of Trusts* 6 ed (2008) 275-276.

Special circumstances that can legitimately be taken into account to reduce or remove any need for diversification is the smallness of the fund[129] or if the trustees are instructed by the settlor (or testator) to retain particular assets within the trust.[130]

4 1 2 2 Duty to obtain and consider proper advice

A further requirement of the Trustee Act 2000 is that trustees must take proper advice on investment decisions.[131] On the question as to the sort of advice that qualifies as being proper advice, Hudson suggests that the following would constitute such advice:[132]

> "It is suggested that consulting a professional in the field in which the investment is to be made would definitely constitute 'proper advice' if the professional was consulted on ordinary business terms and paid in the ordinary manner."

There is no statutory requirement that any advice received should be in writing. However, Moffat encourages trustees to put investment advice in writing. He views written advice as a sensible precaution and argues that it is best practice for trustees.[133]

Trustees can dispense with seeking advice if they reasonably conclude that it is unnecessary or inappropriate to do so in all circumstances.[134] For instance, the trustees may consider the trust fund to be too small or one or more of the trustees might already possess the appropriate skill and knowledge.[135]

5 Significant changes to trust investment law after 2000

The two Law Commissions determined that modern trustees acting within their investment powers should be entitled to be judged by the standards of MPT.[136] However, in some respects the prudent man standard as traditionally understood

[129] Oakley *Modern Law of Trusts* 604.

[130] C Mitchell *Hayton and Mitchell: Commentary and Cases on the Law of Trusts and Equitable Remedies* 13 ed (2010) 375.

[131] S 5(1) of the Trustee Act 2000.

[132] Hudson *Equity and Trusts* 442.

[133] Moffat *Trust Law* 495.

[134] S 5(3) of the Trustee Act 2000.

[135] Pearce & Stevens *Trusts and Equitable Obligations* 622.

[136] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 23 and 99.

was incompatible with MPT.[137] Stated differently, the English law of trusts presented a number of obstacles to the implementation of MPT.[138] In this section, the law relating to trustee investment before and after 2000 is examined to show which areas of trustee investment changed, and explain how these areas changed in order to accommodate MPT.

5 1 The limitation to certain types of investment

The Trustee Act 2000 introduces a new wide general power of investment:[139]

> "... a trustee may make any kind of investment that he could make if he were absolutely entitled to the assets of the trust."

Almost any form of investment is thus permissible,[140] provided the safeguards discussed earlier in the chapter are employed.[141] Under the Trustee Investments Act 1961, trustees were limited to certain types of investment.[142] Hudson explains that what has changed is that trustees are now presumed to be free to make any suitable investments in the absence of any express provision to the contrary, whereas before trustees were presumed to be capable only of making a limited range of investments in the absence of any provision to the contrary.[143]

5 2 The isolation approach

The historical assumption of the prudent man standard was that each investment should be evaluated separately, rather than be considered as part of a portfolio of investments.[144] This approach is referred to as the isolation approach in chapter 4.[145] In contrast, MPT emphasises the evaluation of the investment portfolio "holistically

[137] Moffat *Trust Law* 482.
[138] Watt *Trusts and Equity* 411.
[139] S 3(1) of the Trustee Act 2000.
[140] Mowbray et al *Lewin on Trusts* 1271
[141] See para 4 1 above.
[142] Watt *Trusts and Equity* 411.
[143] Hudson *Equity and Trusts* 433.
[144] Moffat *Trust Law* 482.
[145] See chapter 4 para 3 3 3.

rather than on an asset-by-asset basis".[146] The isolation approach is thus incompatible with MPT.[147]

When the opportunity arose through the pleadings in *Nestle v National Westminster Bank Plc*[148] ("*Nestle*"), the court was prepared to modify the prudent man standard. Before discussing the facts of the case, attention is drawn to an important paragraph in the court of first instance where Hoffmann J stated the following:[149]

> "Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation."

In support of his proposition that trustees are entitled to be judged by the standards of MPT, Hoffmann J cited the American academic Gordon's influential article on MPT.[150]

5 2 1 The facts of the Nestle case

The testator, William Nestle, died in 1922 and left his estate on trust for various descendants. The trustee of the trust was National Westminster Bank.[151] The testator held a substantial portfolio of investments worth about £54 000. The portfolio was reasonably well balanced for the time: it comprised 26% fixed interest securities and 74% equities.[152] The plaintiff, Miss Nestle, was the remainder beneficiary under the trust of her grandfather, William Nestle. Miss Nestle became solely and absolutely entitled to the trust fund in 1986, by which date the nominal capital value of the fund had increased to around £269 000.[153] The increase in the value of the trust fund from £54 000 to £269 000 might be thought to be a substantial

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[146] Chukwu (2017) *Ann Surv Int'l & Comp* 78 footnote 27.
[147] Moffat *Trust Law* 482-483.
[148] (1996) 10 (4) T.L.I. 112 (decided in 1988 but not reported until 1996).
[149] Moffat *Trust Law* 483 referring to *Nestle v National Westminster Bank Plc* (1996) 10 (4) T.L.I. 112 113.
[150] Getzler "Duty of care" in Birks & Pretto *Breach of Trust* 74; NA Clayton "The duty of a trustee to be prudent and fair" (1998) 3 *J I B L* 284 286.
[151] S Lofthouse "Nestle v National Westminster Bank Plc: flawed reasoning?" (1997) *PCB* 232 232.
[152] *Nestle v National Westminster Bank Plc* (1993) 1 W.L.R. 1260 1265-1266.
[153] 1263.

improvement; however, during the same period, the cost of living had multiplied by a factor of 20.[154] Miss Nestle complained that, after adjusting the 1922 value for changes in the retail prices index to date, it should have been worth more or less £1 million.[155] What is more, she alleged that if the original portfolio balance between equities and fixed interest securities had been maintained until 1986, the fund would have been worth over £1.8 million.[156]

There were four main strands to the Miss Nestle's case: first, the trustee misunderstood the investment clause in the will; second, the trustee failed to conduct a regular and periodic review of the investments; third, throughout the trust period, but in particular in the later stages when there were income beneficiaries domiciled abroad, the trustee retained or bought too high a proportion of fixed interest securities and too few ordinary shares; and four, to the extent that the trustee did invest in ordinary shares, it concentrated too heavily on shares in banking and insurance companies to the exclusion of other sectors.[157]

The Court of Appeal found that the first complaint was proved. Miss Nestle alleged that the trustee had failed to understand the investment clause, largely because it had failed to seek legal advice as to its meaning.[158] Consequently, the trustee believed that its investment options were much narrower than was the case.[159] The evidence showed that the trustee continually misunderstood the investment clause, and there is nothing to show that it ever understood it correctly.[160]

Regarding the second complaint, the court found that the trustee failed to conduct regular and periodic reviews of the trust's investments before 1959.[161] However, the court held that the misunderstanding of the investment clause and the failure to conduct periodic reviews do not by themselves, whether separately or together,

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[154] Mitchell *Law of Trusts and Equitable Remedies* 377.

[155] Lofthouse (1997) *PCB* 233.

[156] Watt *Trusts and Equity* 417.

[157] *Nestle v National Westminster Bank Plc* (1993) 1 W.L.R. 1260 1275.

[158] Penner *Law of Trusts* 279.

[159] Lofthouse (1997) *PCB* 233.

[160] *Nestle v National Westminster Bank Plc* (1993) 1 W.L.R. 1260 1275.

[161] 1275.

afford the plaintiff a remedy.[162] In order for Miss Nestle to discharge her burden of proof, she had to show that:[163]

> "... through one or other or both of those causes, the trustees made decisions which they should not have made or failed to make decisions which they should have made. If that were proved, and if at first sight loss resulted, it would be appropriate to order an enquiry as to the loss suffered by the trust fund."

Miss Nestle also complained that after 1960 the trustee's investment favoured the income beneficiaries at the expense of herself, the capital beneficiary.[164] After 1960, the trustee invested a substantial portion of the trust fund in fixed-income securities.[165] The court found that, after taking the savings in estate duty and capital transfer tax into account, the investment policy did not produce a less satisfactory result for the capital beneficiary than an investment in equities. The trustee's investment policy still had the effect of preserving trust capital.[166] It followed that Miss Nestle had suffered no loss and the court held that the claim of discrimination in favour of the income beneficiaries failed on the facts.[167]

The final complaint was in regard to the diversification of the fund. Miss Nestle did not suggest that the proportion of equities should at any stage back to 1960 have been higher than it was. Her complaint was rather that the equities should have been diversified. The fund in 1960 was of a total value of around £105 000, of which £16 000 (or 15%) was in fixed interest securities and £89 000 (or 85%) was in equities. All the equities were, however, bank or insurance shares.[168] The *onus* was on Miss Nestle to prove that she had suffered a loss because the equities were only concentrated in bank and insurance shares. The court found that she did not provide such proof:[169]

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[162] 1275-1276.
[163] 1276.
[164] 1270 and 1284.
[165] 1271.
[166] 1284.
[167] 1271; Lofthouse (1997) *PCB* 232.
[168] *Nestle v National Westminster Bank Plc* (1993) 1 W.L.R. 1260 1266.
[169] 1269.

> "She has not even provided any material which would enable the court to assess the strength of, or value, the chance which she claims she has lost."

Consequently, all of Miss Nestle's claims were dismissed because she had failed to show that a breach of trust resulting in actual loss had occurred.[170]

There are two possible explanations for the approach taken by the court in *Nestle*. The first is that the result very much turned on the defendant trustee winning the battle of the experts as to the investment expertise to be expected of trustees.[171] The second is a more sophisticated explanation for the Court of Appeal's decision. The explanation is that it applied the *Hastings-Bass* rule to determine whether a trustee should be liable for imprudent investment.[172] The general principle of the rule is as follows:[173]

> "If trustees make a decision on wholly wrong grounds, and yet it subsequently appears, from matters which they did not express or refer to, that there are in fact good and sufficient reasons for supporting their decision, then I do not think that they would incur any liability for having decided the matter on erroneous grounds; for the decision itself was right."

Applied to the *Nestle*, it means that:[174]

> "... while the bank was clearly 'in breach' to the extent that it woefully misunderstood the scope of the investment clause, it was not 'in breach' in so far as the investment decisions that it did make were held not to cause loss, because they *could have been justified* as valid investment decisions *had they known* their actual investment powers." [Penner's emphasis.]

Watt states that the *Hastings-Bass* rule is not appropriate for reviewing the prudence of the investment process adopted by trustees. Therefore, according to Watt, the court mistakenly applied the rule in *Nestle*.[175] Watt rather prefers an approach where a breach of trust is determined by reference to trustees' conduct

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[170] 1274, 1281 and 1285.

[171] Penner *Law of Trusts* 280.

[172] Watt *Trusts and Equity* 419. The rule takes its name from the case of *In re Hastings-Bass* [1975] Ch 25: Hudson *Equity and Trusts* 380.

[173] 419; Penner *Law of Trusts* 280.

[174] Penner *Law of Trusts* 280; see also Lofthouse (1997) *PCB* 233.

[175] Watt *Trusts and Equity* 420.

and not by reference to “the outcomes that their conduct happened to produce”.[176] The focus of this dissertation does not warrant further discussion of the *Hastings-Bass* rule.

There are conflicting opinions on whether the judges in the Court of Appeal endorsed Hoffmann J’s approach.[177] Reed and Wilson are of the opinion that the approach taken by Hoffmann J was approved by the Court of Appeal.[178] However, Duckworth does not share this view:[179]

> “The *Nestle* case went to the Court of Appeal where, sadly, none of the judges endorsed Hoffmann J’s acceptance of modern portfolio theory.”

Nevertheless, it is submitted that the total portfolio approach should be regarded as part of English trust law, at least from 1996. There are three reasons for this submission: first, the total portfolio approach was adopted by Her Majesty’s Treasury in its Consultation Paper on the Investment Powers of Trustees published in 1996.[180] Therefore, according to Oakley, from this date the total portfolio approach must be regarded as part of the general law.[181] Second, writing extra-judicially, Lord Nicholls endorsed the approach as put forward by Hoffmann J in *Nestle* at first instance. In his 1995 article, Lord Nicholls states the following:[182]

> “Investment policy is aimed at producing a portfolio of investments which is balanced overall and suited to the needs of the particular trust. Different investments are accompanied by different degrees of risk, which are reflected in the expected rate of return. A large fund with widely diversified portfolio of securities might justifiably include modest holdings of high risk securities which would be imprudent and out of place in a smaller fund. In such a case it would be inappropriate to isolate one particular investment out of a vast portfolio and enquire whether that can be justified as a trust investment. Such a 'line by line' approach is misplaced. The inquiry, rather, should be to look at the particular investment and enquire whether that is justified as a holding in the context of the overall portfolio. Traditional warnings against the need for trustees to avoid

[176] 421.

[177] See para 5 2 above.

[178] Reed & Wilson *Trustee Act 2000* 53.

[179] Duckworth (1997) *PCB* 31.

[180] Hayton (1999) *Vand J Transnat’l L* 557.

[181] Oakley *Modern Law of Trusts* 593.

[182] Mitchell *Law of Trusts and Equitable Remedies* 375.

speculative or hazardous investments are not to be read as inhibiting trustees from maintaining portfolios of investments which contain a prudent and sensible mixture of low risk and higher risk securities. They are not to be so read, because they were not directed at a portfolio which is a balanced exercise in risk management."

Third, when the authors of *Lewin on Trusts* state that modern trustees are entitled to be judged by "the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation",[183] they do not refer to the Trustee Act 2000 as authority but rather to Lord Nicholls' article and to the lower court decision of Hoffmann J in *Nestle*.[184]

The Trustee Act 2000 does not mention MPT or the total portfolio approach directly. However, according to the Explanatory Notes that accompany the Act, the Act does take account of MPT indirectly. The Explanatory Notes state that the definition of the "standard investment criteria" accords with MPT:[185]

"The definition of the standard investment criteria in section 4(3) is closely modelled on section 6(1) of the Trustee Investments Act 1961 and accords with modern portfolio theory."

5 3 The inability to diversify effectively

Trustees have long recognised the importance of diversification through the holding of a varied portfolio of investments.[186] For instance, the Trustee Investments Act 1961 required that trustees had to have regard to the need for diversification of investments so far as appropriate to the circumstances of the trust.[187] One commentator believes that trustees have been recognising the importance of diversification from as far back as 1886. Lofthouse argues that the desirability of diversification has been known since the *Learoyd* case. He states that:[188]

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[183] Mowbray et al *Lewin on Trusts* 1287.

[184] 1287 footnote 31.

[185] Note 25 of the Explanatory Notes, which accompany the Trustee Act 2000.

[186] Thornton (2008) *Cambridge LJ* 400.

[187] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 14.

[188] Lofthouse (1997) *PCB* 238 and 242.

"Diversification seems an essential course of action for a prudent trustee mindful of his duty to make an investment for the benefit of other people for whom he felt morally bound to provide."

However, it seems from the findings of *Nestle* that diversification is a modern notion in the English law of trusts.[189] One specific complaint in *Nestle* was that the trustee failed to diversify the investments in equities away from the original investments in bank and insurance shares during the period from 1922 to 1960.[190] Hoffmann J in the trial judgment was of the view that the allegation was unfounded. He regarded that it was unreasonable for the virtues of diversification to have been appreciated in the first half of the twentieth century.[191] Staughton LJ in the Court of Appeal noted that there should have been diversification in the1950s, rather than from 1960 onwards. However, he went on to state that he could not accept that failure to diversify between 1950 and 1960 "was a course which no prudent trustee would have followed".[192]

The Trustee Act 2000 in effect re-enacts the section in the Trustee Investments Act 1961 that deals with diversification.[193] But this does not mean that the Trustee Act 2000 did not bring about any changes. It is submitted that after 2000 trustees have been able to diversify trust investments quite differently than before. As discussed above, from a diversification perspective, it is more effective to choose investments that have offsetting risks.[194] A major improvement of the Act is that it better equips trustees to choose investments with offsetting risks since trustees can now make any kind of investment. Furthermore, as a consequence of the *Nestle* case, trustees are entitled to be judged by the total portfolio approach as opposed to the isolation approach. The end result is that trustees have been able to diversify more effectively since 2000.

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[189] Penner *Law of Trusts* 279.

[190] *Nestle v National Westminster Bank Plc* (1993) 1 W.L.R. 1260 1281.

[191] Clayton (1998) *J I B L* 285.

[192] *Nestle v National Westminster Bank Plc* (1993) 1 W.L.R. 1260 1281.

[193] Reed & Wilson *Trustee Act 2000* 44.

[194] See para 4 1 2 1 above.

5 4 The rule against the delegation of investment functions

The Trustee Act 2000 confers on trustees acting collectively a power to authorise any person to exercise as their agent any or all of what are termed their "delegable functions".[195] The delegable functions of trustees are any function other than:[196]

> "(a) any functions relating to whether and in what way any assets of the trust should be distributed, (b) any power to decide whether any fees or other payments due to be made out of the trust funds should be made out of income or capital, (c) any power to appoint a person to be a trustee of the trust, or (d) any power conferred by any other enactment or the trust instrument which permits the trustees to delegate any of their functions or to appoint a person to act as a nominee or custodian."

Since the section does not exclude the power to delegate the management of trust investments, trustees are able to delegate their investment functions to an agent, in this case, an investment manager.[197]

Before the Act, trustees had to decide personally not merely on an investment policy but also on individual investment transactions. No general provision existed enabling trustees to delegate to others their discretionary trust functions.[198] Trustees were, therefore, not entitled to delegate the selection of trust investments; they were only permitted the delegation of administrative functions.[199] Trustees could appoint a stockbroker to carry out transactions, but it was the trustees who were required to decide which shares were to be bought and sold.[200] Therefore, in the absence of express powers in the trust instrument to do so, trustees could not employ discretionary fund managers.[201]

The limitation on trustees' powers of delegation constituted a serious impediment to the administration of trusts. Trusteeship is a specialised task that often requires professional skills that a particular trustee might not have. For example, portfolio

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[195] R Wilson "The tension between trustees and investment managers: part 1" (2003) 1 *PCB* 31 34.

[196] S 11(2) of the Trustee Act 2000.

[197] S Panesar "The Trustee Act 2000" (2001) 12 *ICCLR* 151 154.

[198] 154; Le Poidevin (2009) *T & T* 596.

[199] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 45; F Barlow "The flexibility of family trusts" (2013) 19 *T & T* 255 256.

[200] Wilson (2003) *PCB* 34.

[201] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 46; Hayton (1999) *Vand J Transnat'l L* 564.

management might be too intricate for some trustees and they will be compelled to engage experts.[202] The two Law Commissions found that it is essential for trustees of larger trusts to delegate investment functions:[203]

> "In practice, for any trust that has substantial investments, the employment of a discretionary fund manager is a necessity."

Wilson describes the fact that trustees can now employ an investment manager with the discretion as to which investments are bought and sold as the main innovation of the Trustee Act 2000.[204]

5 5 The unavailability of total return investing

The Trustee Act 2000 significantly widened trustees' investment powers. However, trustees continue to be constrained in their investment decisions in one area. Trustees are restricted by the combination of the rules that classify trust receipts as income or capital, and the overarching duty to balance the interests of income beneficiaries (also called life tenants) and capital beneficiaries (also called remaindermen).[205]

In a trust where there is only one class of beneficiaries with identical rights, the source of investment returns is generally immaterial.[206] However, where there are successive beneficial interests, such as the fairly common scenario in which one beneficiary has a life interest that is followed by a transfer of the trust capital to another beneficiary, the character of the different sources of revenue becomes significant.[207] The governing principle in the English law of trusts is that the life tenant is entitled only to income and the capital beneficiary is entitled only to capital.[208] This rule is referred to as the traditional distribution rule in chapter 4.[209]

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202 Chukwu (2017) *Ann Surv Int'l & Comp* 109.

203 The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 46.

204 Wilson (2003) *PCB* 34.

205 The Law Commission *Capital and Income in Trusts: Classification and Apportionment* (2009) Law Com No 315 33.

206 British Columbia Law Institute *Total Return Investing by Trustees* (2001) Report 16 4. For tax purposes, it may well be material whether gains are of an income or capital nature.

207 Schanzenbach & Sitkoff (2009) *ACTEC J* 323 footnote 74.

208 The Law Commission *Capital and Income in Trusts* 9.

209 See chapter 4 para 4 4 4.

Another common feature of the English law of trusts is that trustees are under a duty to balance the competing interests of income and capital beneficiaries. Therefore, trustees must maintain the value of the trust capital while providing a proportionate income; they cannot invest entirely for capital growth, nor can they invest entirely for income return.[210]

Investing without being constrained by the traditional distribution approach is known as total return investing.[211] This important feature of MPT focuses on all the returns generated from a portfolio of assets regardless of whether the returns take the form of income or capital.[212] Total return investing potentially delivers a higher rate of return than one that isolates income returns from capital returns, because it "facilitates the spreading of investments and removes restrictions from trustees' choices".[213]

There are different ways of facilitating total return investing. One method is to use a "power of allocation". A power of allocation gives trustees a power to allocate capital receipts to income, and income receipts to capital in order to establish a balance between income and capital beneficiaries.[214] Another method is the "percentage trust". A percentage trust enables total return investing by requiring trustees to distribute a certain percentage of the value of the trust to the income beneficiary each year. What a fair percentage would be is determined either by the settlor or by legislation.[215]

Concerns regarding the law governing the treatment of capital and income in trusts were raised in 2000 during the parliamentary debates on the Trustee Bill. The matter was referred to the English Law Commission. The Law Commission commenced work on the project in 2003, published a Consultation Paper in 2004, and made recommendations in 2009.[216] Six points were clear from the consultation exercise: first, the Law Commission in its 2009 report noted that the law does not

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[210] The Law Commission *Capital and Income in Trusts* 33.

[211] See chapter 4 para 4 4 4.

[212] A Werker "The percentage trust: uniting the objectives of the life tenant and remainderperson in total return investing by trustees" (2006) 25 *Est Tr & Pensions J* 329 331.

[213] The Law Commission *Capital and Income in Trusts* 34.

[214] 38-39.

[215] The Law Commission *Capital and Income in Trusts: Classification and Apportionment (Summary)* (2009) Law Com No 315 7 footnote 12.

[216] 1-2.

prohibit a settlor from establishing a power of allocation in the trust instrument[217] or constituting a percentage trust.[218] Second, total return investing was, however, not being employed in private trusts. Settlors and their advisers are usually unwilling to venture into an unfamiliar model.[219] Third, despite it not being employed, there are considerable support for total return investing within the trust industry.[220] Fourth, of the two total return investing models, the Law Commission preferred the percentage trust:[221]

> "We would add that in our view, the model for total return investment that we think most likely to be successful is not the power of allocation, as originally envisaged ..., but the percentage trust."

Fifth, the Law Commission explained that there are, however, significant obstacles to the widespread adoption of total return investing in England and Wales. A major technical impediment to the adoption of total return investing is that the tax system for trusts is based exclusively on the traditional income/capital dichotomy. Therefore, from a tax perspective, the structure of the two models of total return investing does not map onto the current tax system.[222] Consequently, tax considerations prevented the Law Commission from recommending that total return investing be made available to private trusts:[223]

> "We share the inevitable disappointment of many in the trust industry that in the light of current tax law and policy we have decided not to make any recommendations for total return investment for private trusts."

Sixth, despite the tax issues, the Law Commission remained of the view that total return investing is an important step for England and Wales.[224] Accordingly, the

[217] The Law Commission *Capital and Income in Trusts* 38.
[218] 45.
[219] 39.
[220] 57.
[221] 75.
[222] 45.
[223] 75.
[224] The Law Commission *Capital and Income in Trusts (Summary)* 7.

commission recommended that more work be done in order to enable trustees to use total return investing somewhere in the future:[225]

> "Accordingly, we conclude this Part with a recommendation that HMRC [Her Majesty's Revenue and Customs] and HM Treasury [Her Majesty's Treasury] work with the trust industry to devise a mechanism for total return investment in a way that facilitates investment while remaining satisfactory from the point of view of taxation."

Up until today, further work has only been done in relation to charitable trusts but not in the private trust space. In 2009, the Law Commission noted that trustees were already investing profitably on a total return basis in the charitable sector.[226] A number of large charitable trusts in England and Wales adopted an approach similar to the approach under percentage trusts. Of course, for charitable trusts, unlike private trusts, the distinction between capital and income has no tax implications.[227] In order to adopt a total return approach, the only requirement for trustees was to seek prior approval from the Charity Commission.[228] The Law Commission recommended in its 2009 report that this restriction should be removed.[229] Accordingly, from 1 January 2014, charitable trusts have been able to adopt a total return investment strategy without securing approval from the Charity Commission.[230]

Taking the above-mentioned into consideration, it is submitted that trustees of private trusts in England face a similar problem than trustees in South Africa. Trustees in England are under an obligation to preserve the real value of a trust fund (as opposed to merely seeking to protect its nominal value) and, because of trustees' duty of impartiality, they are also obliged to produce adequate income for income

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[225] The Law Commission *Capital and Income in Trusts* 75; see also Chukwu (2017) *Ann Surv Int'l & Comp* 81.

[226] The Law Commission *Capital and Income in Trusts* 38.

[227] The Law Commission *Capital and Income in Trusts: Classification and Apportionment (Analysis of Responses)* (2004) Law Com No 175 43.

[228] The Law Commission *Capital and Income in Trusts (Summary)* 9. The Charity Commission is the independent regulator of charities in England and Wales: <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/353957/Total_return_investment_for_permanently_endowed_charities.pdf> (accessed 13-06-2018).

[229] The Law Commission *Capital and Income in Trusts (Summary)* 9.

[230] https://www.gov.uk/government/publications/charity-commission-regulations-total-return (accessed 13-06-2018).

beneficiaries.[231] The problem for trustees, however, is that it is extremely difficult to achieve this goal without having total return investing at their disposal.[232]

5 6 The anti-netting rule

The anti-netting rule (or the rule against set-off)[233] has been part of English law since the nineteenth century.[234] The rule provides that where the court finds that the trustees have invested imprudently, the trustees cannot offset the loss from such an investment against a gain from another breach of trust,[235] or against a gain from an investment not involving a breach of trust.[236] The rule has an exception: losses from a breach of trust can be offset by gains from other breaches of trust if those other breaches are not separate and distinct.[237]

At first glance it would seem that the anti-netting rule constitutes an uneasy fit with the concept of portfolio-wide assessment of investment performance, in other words, the total portfolio approach.[238] Yet, the Trustee Act 2000 does not abolish the rule. One can thus assume that the anti-netting rule is not viewed in English law to be in conflict with the total portfolio approach. The question whether the rule is indeed in conflict with the total portfolio approach is discussed in chapter 7.[239]

6 Conclusion

After the South Sea Bubble burst in 1720, the English Court of Chancery developed a court-made list of investments that were presumptively proper for trustees. The broadening of the range of acceptable securities occurred as a result of statutory changes in the mid-nineteenth century. The securities of the statutory legal list were all fixed-income securities. During the same period, corporate stock was not considered good security for trustee investing. The 1925 Act consolidated

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[231] Moffat *Trust Law* 502-504; Hudson *Equity and Trusts* 357-359.

[232] See chapter 7 para 5 2 3.

[233] Watt *Trusts and Equity* 412.

[234] *Bartlett v Barclays Bank Trust* (1980) 2 W.L.R. 430 447.

[235] Mowbray et al *Lewin on Trusts* 1567; *Bartlett v Barclays Bank Trust* (1980) 2 W.L.R. 430 447.

[236] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 23 footnote 61.

[237] Watt *Trusts and Equity* 412.

[238] For a discussion of the total portfolio approach, see para 5 2 1 above.

[239] See chapter 7 para 7 2 4.

the statutory legal list but did not extend it to company stock. Trustees without a wide express power of investment were thus limited only to narrow categories of investment.

The level of care and skill required of trustees was the same whether they were choosing from the statutory legal list or from a wider range of investments authorised by the trust instrument. The general duty of trustees was to act honestly and fairly and to "take all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own". This standard is referred to as the prudent man standard. The standard was later modified in the case of powers of investment. It was stated that:

> "The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide."

As a consequence, trustees had to adopt a more cautious investment policy than individual investors. More specifically, trustees were required to avoid all investments that were attended with hazard.

The weakness of the legal list philosophy began to emerge in the 1930s. Several factors appeared that contributed to the disenchantment with fixed-income investments, inflation being the most important factor. As a result of several studies, debates, and requests for reform, the Trustee Investments Act 1961 was enacted. The purpose of the Act was to allow trustees to invest in assets with a greater potential for return, in particular in shares, without taking an undue risk with the trust capital. The two Law Commissions in their joint Law Commissions' report accepted that, at the time, the Trustees Investment Act 1961 was a significant step forward. However, they found that the provisions of the Act operated in a way that was not only needlessly restrictive, but also positively detrimental to most trusts to which it applied. By perpetuating the old approach of a list of investments, the Act was out of step with modern thinking. Consequently, the two Law Commissions recommended reform that would lessen the administrative burden and associated costs of the Act and facilitate the use of modern investment services in trusts.

Other developments also took place in the period before the enactment of the Trustee Act 2000. Trustees had to avoid all investments of a hazardous nature under the old authority of *Learoyd*. The difficulty with this approach was that all investments necessarily involve some element of risk and it is thus impossible for trustees to make investments that are entirely risk-free. Brightman J modified the approach slightly in *Bartlett* by drawing a distinction between a prudent degree of risk on the one hand and hazard on the other.

The Trustee Act 2000 broke with the past by doing away with the authorised list principle and instead conferring the widest possible investment powers on trustees. Appropriately, these wide powers of investment are coupled with adequate safeguards. In addition to three general duties – the duty to act in the best interests of beneficiaries, the duty to act impartially, and the statutory duty of care – the Act imposes two specific duties on trustees in order to protect the interests of beneficiaries: first, trustees must have regard to what is termed the standard investment criteria and, second, they are under a duty to obtain and consider advice.

The two Law Commissions determined that modern trustees acting within their investment powers should be entitled to be judged by the standards of MPT. However, the English law of trusts presented a number of obstacles to the implementation of MPT. The Trustee Act 2000 removed most of these obstacles, either directly or indirectly, while the *Nestle* case played a significant role in eliminating one obstacle in particular. First, by permitting investment in any type of investment, the Act removed the primary obstacle to trustees, namely being limited only to certain types of investment. Second, by virtue of the *Nestle* case, modern trustees are not judged by the isolation approach anymore, but are entitled to be judged by the total portfolio approach. Third, since the Act permits any type of investment and since trustees are entitled to be judged by the total portfolio approach, trustees are better equipped to choose investments with offsetting risks. As a consequence, trustees are able to diversify more effectively. Fourth, a major innovation of the Act is that trustees can employ an investment manager with the discretion as to which investments are to be bought and sold. Before 2000, in the absence of express powers in the trust instrument to do so, trustees were not able to delegate their investment functions. Unfortunately, one obstacle was not removed. Tax considerations prevented the English Law Commission from recommending the use of total return investing. Trustees are thus unable to take full advantage of MPT. The Law Commission did however recommend that more work be done in order to enable trustees to use total return investing in the future.

Finally, the two Law Commissions gave no indication suggesting that the anti-netting rule is in conflict with the total portfolio approach. Accordingly, the Trustee Act 2000 does not abolish the rule.

The next chapter examines the development of trustees' investment standards in New Zealand. Chapter 6 will show that New Zealand has also modernised trustee investing by integrating MPT principles into its trust law. Thereafter, chapter 7 will review, compare and analyse the development of trustees' investment standards in the three relevant foreign jurisdictions.

CHAPTER 6 – THE DEVELOPMENT OF TRUSTEES' INVESTMENT STANDARDS IN NEW ZEALAND

1 Introduction

This chapter describes and analyses the development of trustees' investment standards in New Zealand. Prior to 1988, trustee investment was governed by a number of rules that effectively prevented trustees from following a modern portfolio theory ("MPT") approach to investing. Thereafter, amendments were made to legislation that were designed to permit trustees to use MPT techniques. In fact, this was the first legislative attempt to design legislation that is favourably disposed towards MPT, preceding enactments in New York by a few years.[1]

In 2013, the New Zealand Law Commission (referred to in this chapter as the "Law Commission") found that the 1988 changes did not go far enough to permit trustees to adopt the full MPT approach. Consequently, the Law Commission recommended that any obstacles that pose difficulties to the full integration of MPT into trust law should be removed. Based on the Law Commission's recommendations, the Trusts Act 2019 obtained royal assent on 30 July 2019, the final stage in becoming an act of Parliament. The Act will enter into force eighteen months after royal assent, thus on 30 January 2021.

The purpose of the chapter is to provide answers to four important questions: first, why was it necessary for the 1988 changes to have taken place? Second, what changes were made to trust investment law? Third, what further changes will the Trusts Act 2019 make once it enters into force? Fourth, is MPT the new standard of prudence in New Zealand trust law? In answering these questions, the chapter explains the problems that trustees face when they are unable to rely on a rule based on MPT, describes how certain areas of trustee investing must change in order for MPT to be fully integrated into trust law, discusses the advantages of the full integration of MPT, and provides a better understanding of New Zealand's current and future position with respect to MPT.

Following this introduction, the chapter is divided into four sections, which are summarised in the conclusion at the end of the chapter. Section 2 discusses trust investment law before 1988. The section first states what the initial acceptable type

[1] See para 3 below.

of investments was; and second, it describes the standard of care that was required of trustees and illustrates its application by discussing a well-known New Zealand court case. Section 3 discusses the position after 1988. The section starts by providing the reasons why there was a need for reform and then examines how trust investment law was changed. The first part of section 4 provides background to the Law Commission's full-scale review of the law of trusts and summarises the conclusion that it reached regarding trustees' investment functions in particular. The second part of section 4 discusses the areas of trustee investing that the Law Commission recommended must change and the provisions in the Trusts Act 2019 that correspond to the proposed changes. Section 5 investigates whether New Zealand has moved from permitting the use of MPT to perhaps requiring investing in accordance with MPT and whether this position will remain after the Trusts Act 2019 enters into force.

2 Trust investment law before 1988

2 1 The legal list approach

Like other common law jurisdictions, New Zealand has traditionally followed English trustee legislation and has generally adopted English case law in the area of trust investment law.[2] Following the practice in England, trustee investment in New Zealand was based on a list of approved forms of investment prior to 1988.[3] This is hereafter referred to as the "legal list approach". Trustees were permitted to invest only in investments specifically authorised by the Trustee Act 1956. The will or trust deed could allow for a wider range of investments, but if it did not, the trustees could only invest in one of the forms of investment prescribed by law.[4]

Initially, the classes of authorised investment were essentially confined to fixed-income investments such as government stock, local authority stock, bank and

[2] G Cone, C Shan & S Barber "A trusts act for New Zealand" (2019) 25 *T & T* 891 891; Ontario Law Reform Commission *Report on the Law of Trusts* (1984) Volume 1 200.

[3] NC Kelly, C Kelly & G Kelly *Garrow and Kelly Law of Trusts and Trustees* 6 ed (2005) 583.

[4] New Zealand Law Commission *Review of the Law of Trusts – The Duties, Office and Powers of a Trustee* (2011) Issues Paper 26 72.

building society deposits, and first mortgages of land.[5] A 1974 change to the Trustee Act 1956 expanded the list of authorised investments to include a limited range of equities.[6] Unlike England's Trustee Investments Act 1961, the Trustee Act 1956 did not classify the authorised investments into narrower-range and wider-range investments.[7] However, similar to English law, the Act permitted trustees to invest only in shares that met certain qualifying conditions. It confined trustee investment to investment in companies that were incorporated in New Zealand, had a paid-up share capital of $2 500 000, and had paid a dividend of at least 5% on all its issued shares in each of the five years preceding the investment.[8] In spite of the 1974 change, in practice, many trustees continued to invest predominantly in fixed-income investments.[9]

2 2 The standard of care

In *Jones v AMP Perpetual Trustee Company*[10] ("*Jones*"), the court confirmed that when a trustee exercises his powers of investment, he must "take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide".[11] The standard of care imposed on New Zealand trustees thus reflected the development of the law in England.[12] This standard was required whether trustees invested in terms of the trust instrument or the Trustee Act 1956.[13]

In *Jones*, the trustee of a company pension plan was sued by the members of the pension plan.[14] The trustee, AMP Perpetual Trustee Company ("Perpetual"), invested in a unitised investment-linked fund, which was referred to in the case as

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[5] Kelly et al *Law of Trusts* 583; G Cone "Sharing away trustees powers – New Zealand" (2013) 19 *T & T* 712 717.

[6] Ontario Law Reform Commission *Report on the Law of Trusts* 200.

[7] 204.

[8] 203-204.

[9] Kelly et al *Law of Trusts* 583.

[10] [1994] 1 NZLR 690.

[11] *Jones v AMP Perpetual Trustee Company* [1994] 1 NZLR 690 706.

[12] 705.

[13] 705-706; Kelly et al *Law of Trusts* 588.

[14] Kelly et al *Law of Trusts* 599.

"A Unit". A Unit was established and managed by Perpetual's parent company.[15] The trust deed specifically authorised investment in this type of investment.[16] Although A Unit included diversified forms of investment, it was heavily weighted towards investment in shares. With the trust fund heavily weighted towards equities due to its investment in A Unit, it was left exposed to the share market crash in October 1987 and lost substantial value.[17]

Changes were made to the Trustee Act 1956 on 1 October 1988 and the obligation to have an investment strategy arose indirectly from these changes.[18] Perpetual, however, did not complete a formal investment strategy until 6 December 1990. In its formal investment strategy, Perpetual reconfirmed the decision to invest in A Unit.[19]

The members of the pension fund – Jones and the other trust beneficiaries – sued Perpetual to recover the loss they had suffered from having their money invested in Unit A. The beneficiaries alleged that Perpetual breached its obligation to act prudently in the exercise of its powers of investment.[20]

Much of Perpetual's conduct had to be judged in accordance with the law prior to October 1988.[21] Thomas J took the view that the same standard of care was required and applicable to the conduct before and after 1988, and he applied this standard in order to decide whether A Unit was a proper investment. In terms of this standard of care, when exercising a power of investment, trustees should seek advice on matters that they might not understand and act prudently on that advice.[22]

It was held that Perpetual had met the standard of care expected of it throughout the period under consideration.[23] In particular, Perpetual had made proper inquiries and had taken advice; directed its mind to the critical question of what was in the best interests of the trust; kept the investment under review; invested the trust fund

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[15] *Jones v AMP Perpetual Trustee Company* [1994] 1 NZLR 690 690-691.

[16] FP Manns "New Zealand trustee investing: reflecting on modern portfolio theory and the ancient distinction of principle and income" (1998) 28 *Victoria U Wellington LR* 611 625.

[17] *Jones v AMP Perpetual Trustee Company* [1994] 1 NZLR 690 691-692.

[18] See s 13M(d) of the Trustee Act 1956 (as amended).

[19] *Jones v AMP Perpetual Trustee Company* [1994] 1 NZLR 690 709.

[20] 692.

[21] 706.

[22] 693.

[23] 693.

with a reputable company that had performed relatively well as a fund manager; and had chosen an investment suitable for the size of the trust fund.[24] Perpetual was thus held not liable to compensate the members for loss.[25]

One of the complaints by the beneficiaries was that, although changes to the Trustee Act 1956 had come into force on 1 October 1988, no investment strategy was adopted until 6 December 1990. They argued that Perpetual was in breach of its duty to act with care because it waited over two years after the changes to legislation have been made before instituting an investment strategy.[26] Thomas J held that the failure to adopt an investment strategy in 1988 was not in dereliction of Perpetual's duty as trustee for two reasons: first, the concept of "investment strategy" only assumed significance in the formation of trust portfolios during the 1990s. It was thus not appropriate to fault Perpetual for a failure to do something that was not practice at the time that the investment was made.[27] Second, Thomas J considered the investment strategy adopted by Perpetual in 1990 did not do much more than record what had always been its latent or tacit investment strategy. In other words, "[i]t made formal that which had been informal".[28]

3 Trust investment law after 1988

In 1986, the Working Party on Trust Investment Powers (hereafter referred to as the "Working Party") considered the benefits of replacing the legal list approach with the prudent person approach.[29] Under the prudent person approach, trustees are not confined to a list of investments but may invest in any asset, including equities.[30] In considering the prudent person approach as a possible replacement option, the Working Party made frequent reference to United States material and took the

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[24] 712.

[25] 713; Kelly et al *Law of Trusts* 599.

[26] *Jones v AMP Perpetual Trustee Company* [1994] 1 NZLR 690 692 and 709.

[27] 709-710; AS Butler "Modern portfolio theory and investment power of trustees: the New Zealand experience" (1995) 7 *Bond LR* 119 150.

[28] *Jones v AMP Perpetual Trustee Company* [1994] 1 NZLR 690 710.

[29] Kelly et al *Law of Trusts* 603; Butler (1995) *Bond LR* 121 footnote 6.

[30] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 72.

developing concept of MPT into account.[31] In the course of its report, the Working Party noted that the legal list approach acted as an obstacle to the use of MPT.[32]

The need to replace the legal list approach was made acute by the continuing effects of inflation during the period before 1988. High inflation eroded the funds of capital beneficiaries, and payments from the trusts of income beneficiaries depreciated substantially every year.[33] Experience has shown that fixed-income investments present minimal risk but provide low returns.[34] On the other hand, a prudent and informed investment in equities often provides a suitable means of escaping inflationary pressures.[35]

After a thorough investigation, the Working Party recommended the abolition of the legal list approach and the adoption of the prudent person approach.[36] Moreover, because the Working Party took the view that the use of MPT techniques would soon become an accepted (or perhaps required) feature of trustee investment practices, it suggested that new legislation ought to attempt to facilitate the use of MPT by trustees.[37]

Following the Working Party's recommendations, the provisions of the Trustee Act 1956 dealing with investment of trust funds were rewritten by the Trustee Amendment Act 1988.[38] The changes came into force on 1 October 1988.[39] Hereafter, the Trustee Act 1956 as amended by the Amendment Act 1988 is referred to as the "Trustee Act 1956 (as amended)". Interestingly, the changes in 1988 are

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[31] Butler (1995) *Bond LR* 121; Kelly et al *Law of Trusts* 603. MPT is sometimes referred to as "portfolio investment theory" or "portfolio theory": Butler (1995) *Bond LR* 119, "portfolio management theory": 143, or "portfolio strategy": Kelly et al *Law of Trusts* 603.

[32] Butler (1995) *Bond LR* 140.

[33] Cone (2013) *T & T* 717. For an example of the corrosive harm of inflation to trust capital, see the discussion of the facts of *Re Mulligan (deceased)* (1998) 1 NZLR 481 in para 5 below.

[34] Cone (2013) *T & T* 717.

[35] Kelly et al *Law of Trusts* 583-584.

[36] Butler (1995) *Bond LR* 140; Manns (1998) *Victoria U Wellington LR* 612.

[37] Butler (1995) *Bond LR* 121.

[38] Butler (1995) *Bond LR* 120-121; Kelly et al *Law of Trusts* 583.

[39] *Jones v AMP Perpetual Trustee Company NZ Ltd* [1994] 1 NZLR 690 705.

the earliest attempt to include MPT into trust legislation,[40] preceding enactments in New York by a few years.[41]

The Amendment Act 1988 made four changes to trust investment law that were designed to assist trustees to follow a MPT approach to investment. The following constitutes a brief summary of these changes.

3 1 Wide powers of investment

The Amendment Act 1988 abolished the legal list approach and replaced it with a provision that empowers trustees to "invest any trust funds, whether at the time in a state of investment or not, in any property".[42] This encourages those trustees who would like to pursue a MPT approach since "no pre-conceptions are expressed about the suitability of a particular investment vehicle for trust investment purposes".[43]

The word "property" is defined in section 2 of the Trustee Act 1956 (as amended). Property includes: "real and personal property, and any estate, share, and interest in any property, real or personal, and any debt, and any thing in action, and any other right or interest, whether in possession or not".[44] The term would even include futures and hedge contracts and the like,[45] which differs significantly from the cautious approach that was taken before 1988.[46]

Establishing high standards to regulate investment selection acts as a counterbalance to trustees' wide powers of investment. Accordingly, the Trustee Act 1956 (as amended) declares all property in principle open to consideration for investment, but investment is subject to trustees' overriding duty of prudence.[47] The

[40] P Panico "Trustees investment powers in international trust law" (2009) 15 *T & T* 96 99; AS Hofri-Winogradow "The stripping of the trust: a study in legal evolution" (2015) 65 *U Toronto LJ* 1 18 footnote 78.

[41] The American Law Institute published the Restatement (Third) of the Law of Trusts in 1992 and the New York State Legislature enacted the Prudent Investor Act in 1995: see chapter 4 para 5 1.

[42] S 13A(1) of the Trustee Act 1956 (as amended); see also s 58 of the Trusts Act 2019. For a discussion of the Trusts Act 2019, see para 4 below.

[43] Butler (1995) *Bond LR* 143.

[44] S 2 of the Trustee Act 1956 (as amended).

[45] For an explanation of futures and hedge contracts, see chapter 7 para 2 2 2.

[46] Kelly et al *Law of Trusts* 585.

[47] Cone (2013) *T & T* 718.

duty of prudence is found in section 13B and section 13C of the Act. According to section 13B, when exercising any power of investment, a trustee must "exercise the care, diligence and skill that a prudent businessperson would exercise in the management of another's affairs".[48] An even higher standard is imposed on professionals who are employed to manage trusts. In terms of section 13C, their conduct must conform to the standard of a prudent person who is engaged in that profession.[49]

Within the broad terms of the duty to invest prudently, section 13E of the Act provides some guidance on how the duty should be applied. The section sets out a list of factors that trustees may have regard to when investing trust property:[50]

> "Without limiting the matters that a trustee may take into account, a trustee exercising any power of investment may have regard to the following matters so far as they are appropriate to the circumstances of the trust: (a) the desirability of diversifying trust investments; (b) the nature of existing trust investments and other trust property; (c) the need to maintain the real value of the capital or income of the trust; (d) the risk of capital loss or depreciation; (e) the potential for capital appreciation; (f) the likely income return; (g) the length of the term of the proposed investment; (h) the probable duration of the trust; (i) the marketability of the proposed investment during, and on the determination of, the term of the proposed investment; (j) the aggregate value of the trust estate; (k) the effect of the proposed investment in relation to the tax liability of the trust; (l) the likelihood of inflation affecting the value of the proposed investment or other trust property."

It is worth noticing that the section does not limit the factors that trustees may take into account; other relevant matters may also be considered. According to Kelly and others, the factors are not listed in order of priority. They also state that while the list of factors is helpful, there is still a need for trustees to consider which factors are relevant and exercise judgement and discretion when making investment decisions.[51]

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[48] S 13B of the Trustee Act 1956 (as amended).

[49] S 13C.

[50] S 13E of the Trustee Act 1956 (as amended).

[51] Kelly et al *Law of Trusts* 590.

3 2 The total portfolio approach

MPT emphasises that an investment portfolio must be evaluated "holistically rather than on an asset-by-asset basis".[52] When this principle of MPT is applied to trust investment law, it means that a trustee's performance should be evaluated in light of the performance of the total portfolio rather than by evaluating each individual investment in a portfolio separately.[53] In chapter 4, this approach is referred to as the total portfolio approach.[54] The approach that assesses the decisions of trustees on an investment-by-investment basis, thus the opposite of the total portfolio approach, is referred to in chapter 4 as the isolation approach.[55]

To some extent, the acceptability of the total portfolio approach is hinted at in section 13E of the Trustee Act 1956 (as amended). Relevant for present purposes are points (a) and (b) of the section:[56]

> "… a trustee exercising any power of investment may have regard to the following matters so far as they are appropriate to the circumstances of the trust: (a) The desirability of diversifying trust investments; (b) The nature of existing trust investments and other trust property …"

Butler states that both these considerations go to the heart of the total portfolio approach: first, because diversification is the means by which a portfolio achieves its stability; and second, because portfolio diversification can only be made in light of the current holdings of the trust fund. These provisions, when considered in conjunction with section 13M of the Act (which states that a court may take any investment strategy in an action for breach of trust into account), tend to support the conclusion that following the total portfolio approach is an acceptable trustee investment strategy.[57]

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[52] LOC Chukwu "Theoretical underpinnings of trust investment law: juxtaposing Nigerian law with current trends in other Common Law jurisdictions" (2017) 22 *Ann Surv Int'l & Comp L* 73 78 footnote 27.

[53] Kelly et al *Law of Trusts* 603-604.

[54] See chapter 4 para 3 3 3.

[55] See chapter 4 para 3 3 3.

[56] S 13E of the Trustee Act 1956 (as amended).

[57] Butler (1995) *Bond LR* 148.

3 3 The recognition of the desirability of diversification

As discussed above, section 13E of the Trustee Act 1956 (as amended) sets out a list of factors that trustees may have regard to in exercising powers of investments.[58] The desirability of diversification is expressly recognised in the list.[59] While arguably there is no duty to diversify under the Act,[60] trustees who do not diversify act at their own peril. For example, if it is believed that trustees have failed to meet the standard of prudence expected of them, beneficiaries may claim for consequential loss. In such cases, the court will consider all relevant circumstances, including any of the factors listed in section 13E. Moreover, section 13M of the Act directs the attention of the court specifically to the issue of diversification.[61] The section allows the court to have regard to two matters in determining whether trustees have acted prudently: first, the court may have regard to whether the trust investments have been diversified; and second, it is open to the court to consider whether the investment was made pursuant to an investment strategy.[62] Since diversification is the only factor that is mentioned in both section 13E and section 13M, one cannot help to feel that the legislator saw diversification as paramount to the interest of beneficiaries.

A factor that can legitimately be considered to reduce or remove any need for diversification is if the trustees are instructed by the settlor (or testator) to retain particular assets within the trust. For example, a prudent drafter can affirmatively state that the trustees are under no duty to diversify with respect to a family farm or shares in a family business.[63]

3 4 The first attempt at abolishing the anti-netting rule

The anti-netting rule has always operated under general trust law. The rule provides that in an action for breach of trust, the court may not set off a loss arising from one investment against a gain from another investment.[64] For example, assume that the trustee of a particular trust imprudently invests half of the trust fund in

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[58] See para 3 1 above.

[59] S 13E(a) of the Trustee Act 1956 (as amended).

[60] Manns (1998) *Victoria U Wellington LR* 628.

[61] Kelly et al *Law of Trusts* 598.

[62] S 13M of the Trustee Act 1956 (as amended).

[63] Manns (1998) *Victoria U Wellington LR* 628.

[64] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 73.

investment "A" and the other half in investment "B", and that the investment results in a substantial profit on the first investment but a loss on the second. In terms of the anti-netting rule, the beneficiaries are entitled to "the profit arising from investment A; and may insist that the trustee must make good the loss on investment B".[65]

In its report, the Working Party recommended that the rule should be abolished. The Working Party took the view that abolishing the rule would be more in line with the application of the general principles of damages.[66] As a result, section 13Q of the Trustee Act 1956 (as amended) was introduced, which is designed to overcome the effect of the anti-netting rule.[67] Section 13Q is clear authorisation for the court to consider offsetting the losses that accrue from an individual investment against gains made on other investments:[68]

> "In considering any action for breach of trust arising in respect of or in relation to any investment by a trustee as a result of which any loss or losses have been, or are expected to be, sustained by the trust, the court may set off, as it thinks just, all or any part of the loss or losses resulting from that investment against all or any part of the gain or gains resulting from any other investment, whether in breach of trust or not."

Whether this section has been successful in eliminating the anti-netting rule is discussed later in the chapter.[69]

4 The Law Commission's recommendations and the Trusts Act 2019

In 2009, the Law Commission decided to commence a full-scale review of the law of trusts.[70] Since 2009, the Law Commission published a series of five issues papers on different aspects of the law of trusts followed by a sixth issues paper, the so-called "Preferred Approach", which outlines its approach to reform in each of the areas covered.[71] Following the six issues papers, the Law Commission delivered its

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[65] Kelly et al *Law of Trusts* 824.

[66] Butler (1995) *Bond LR* 144.

[67] Kelly et al *Law of Trusts* 602.

[68] S 13Q of the Trustee Act 1956 (as amended).

[69] See para 4 4 below.

[70] New Zealand Law Commission *Review of the Law of Trusts – Introductory Issues Paper* (2010) Issues Paper 19 iii; <http://www.lawcom.govt.nz/our-projects/law-trusts> (accessed 12-09-2018).

[71] <http://www.lawcom.govt.nz/our-projects/law-trusts> (accessed 12-09-2018).

report in August 2013.[72] The report concludes that the current legislation underpinning trusts is unsatisfactory and in need of reform. Accordingly, the Law Commission recommended that new legislation be enacted to replace the outdated Trustee Act 1956 (as amended).[73]

Following the Law Commission's recommendation, the Trusts Bill 2016 was introduced to the New Zealand Parliament. The official website of the New Zealand Parliament describes the purpose of the Bill as follows:[74]

> "This bill will replace the Trustee Act 1956 and the Perpetuities Act 1964 to make trust law more accessible, clarify and simplify core trust principles and essential obligations for trustees, and preserve the flexibility of the common law to allow trust law to continue to evolve through the courts."

The lengthy legislative overhaul was complete 30 July 2019, the date that the Trusts Act 2019 obtained royal assent.[75] It should be pointed out that the Act will only enter into force eighteen months after royal assent, thus on 30 January 2021.[76] The reason for this transition period is to ensure that trustees align their practices with the provisions of the Act.[77]

The Act will make important changes to trust law in New Zealand. For purposes of this dissertation, the focus falls on changes relating to trust investment law only. The Law Commission concluded that the Trustee Act 1956 (as amended) does not go far enough to permit trustees to adopt the full MPT approach.[78] Accordingly, it identified four areas of trustee investing that pose particular difficulties to the adoption of the full MPT approach and recommended changes in these areas. The section below

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[72] New Zealand Law Commission *Review of the Law of Trusts – A Trusts Act for New Zealand* (2013) Report 130 i.

[73] Iv.

[74] <https://www.parliament.nz/en/pb/bills-and-laws/bills-proposed-laws/document/BILL_74746/trusts-bill> (accessed 26-09-2018).

[75] Anonymous "The arrival of the Trusts Act 2019" (06-08-2019) *Anderson Lloyd* <https://www.al.nz/the-arrival-of-the-trusts-act-2019/> (accessed 03-12-2019) 1; see also, <http://www.legislation.govt.nz/act/public/2019/0038/latest/DLM7382815.html> (accessed 03-12-2019).

[76] S 2 of the Trusts Act 2019; Cone et al (2019) *T & T* 892.

[77] Anonymous (06-08-2019) *Anderson Lloyd* <https://www.al.nz/the-arrival-of-the-trusts-act-2019/> (accessed 03-12-2019) 1.

[78] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 73.

discusses the Law Commission's recommendations together with the changes the Trusts Act 2019 will make. The discussion below thus provides a view of New Zealand's current position and further clarifies what the position will be once the Trusts Act 2019 enters into force.

4 1 Adoption of the total portfolio approach

As discussed above, section 13E of the Trustee Act 1956 (as amended) hints at the acceptability of the total portfolio approach.[79] However, Butler argues that the section does not go far enough in permitting the adoption of the total portfolio approach. Butler suggests that in order to make the acceptability of the total portfolio approach more obvious, section 13E should rather state that when making investments, trustees must have regard to "the relationship of that investment to other investments in the investment package".[80]

The Law Commission decided not to follow Butler's simple solution to the problem. Rather, it recommended the following two changes to the Act: first, section 13E should be redrafted to provide that trustees may take their overall investment strategy into account when exercising their powers of investment;[81] and second, new legislation should clarify that the rule of general trust law, which requires that the decisions of trustees are assessed on an investment-by-investment basis if their investment decisions are called into question, should be abolished.[82] The Trusts Bill 2016 reflected both these recommendations.[83]

The second recommendation appears to indicate that the isolation approach should be abolished. However, somewhat confusingly, the Law Commission referred to the rule that it wished to abolish as the *anti-netting rule* rather than the *isolation approach*. Nevertheless, it is safe to assume that what the Law Commission had in mind was that trustees should follow the total portfolio approach.

The Trusts Act 2019 indicates the acceptance of the total portfolio approach in the following two ways: first, section 59(1)(n) of the Act requires trustees to consider

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[79] See para 3 2 above.

[80] Butler (1995) *Bond LR* 148.

[81] New Zealand Law Commission *A Trusts Act for New Zealand* 133.

[82] 131.

[83] See ss 52(1)(n) and 55(4) of the Trusts Bill 2016.

their "overall investment strategy" when exercising their power of investment.[84] Second, in terms of section 128 of the Act, in an action for breach of trust, the court may take into consideration whether an investment was made in accordance with an investment strategy:[85]

> "In considering whether a trustee is liable, in respect of any investment made by that trustee, for any breach of trust in respect of any duty … to invest prudently … the court may take into account — (a) whether the trust investments have been diversified, so far as is appropriate to the circumstances of the trust; and (b) whether the investment was made in accordance with any investment strategy."

Once the Act enters into force, the inclusion of section 59(1)(n) in the Trusts Act 2019 will make it easier for trustees to justify the total portfolio approach as a prudent investment strategy in terms of section 128.

4 2 Delegation of trustees' investment functions

The general rule in New Zealand is that trustees must not delegate their duties or powers – not even to co-trustees.[86] There are a few exceptions to the general rule: first, delegation is allowed where such delegation is specifically authorised by the trust instrument.[87] Research by the Law Commission indicates that many modern trust deeds enable trustees to do this.[88] Second, section 29 of the Trustee Act 1956 (as amended) deals with the appointment of agents to carry out certain administrative functions.[89] For example, a stockbroker may be instructed to buy authorised investments of a particular type, but the trustees must personally exercise discretion whether to purchase investments of that particular type.[90] Trustees are declared not to be responsible for the default of agents if the agents are employed in good faith.[91] Third, section 31 of the Act permits trustees to delegate their role in

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[84] S 59(1)(n) of the Trusts Act 2019.

[85] S 128.

[86] Kelly et al *Law of Trusts* 551.

[87] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 20.

[88] New Zealand Law Commission Review of the Law of Trusts – Preferred Approach (2012) Issues paper 31 105.

[89] S 29 of the Trustee Act 1956 (as amended).

[90] Kelly et al *Law of Trusts* 553.

[91] S 29(1) of the Trustee Act 1956 (as amended).

circumstances where they will be absent from New Zealand or will be temporarily incapable of performing their duties because of physical infirmity.[92] Cleary this type of delegation can only occur in strictly defined circumstances.

Under the current default provisions, therefore, trustees are not able to delegate the entire responsibility of selecting and holding investments to an investment manager. Rather, trustees should normally seek expert advice on potential investments, personally assess such advice, and decide whether to accept or reject the advice.[93] The trustees must make the final decision.[94]

The Law Commission acknowledged that it requires considerable skill and judgement to make sound investment decisions in today's world.[95] It also accepted that all investors, whether private individuals or trustees, are faced with an extraordinary range of investment products and services when it comes to building and maintaining a portfolio.[96] Generally, submitters to the Law Commission's issues papers commented that it is not reasonable to expect trustees to possess the same degree of knowledge and expertise as professional investment managers. The Law Commission stated that, since trustees are not allowed to delegate their investment functions, they are not able to use the skill and judgement of professional investment managers fully when making investment decisions.[97] Hence, this limits the ability of trustees to follow a MPT approach to investment.[98] Accordingly, the Law Commission recommended that trustees should be able to appoint investment managers with the authority to make investment decisions.[99] The ability to allow for the appointment of investment managers would thus be the default position, but the terms of a trust can exclude or modify the power.[100] In other words, settlors can contract out of the default position if they do not want trustees to delegate investment decisions in this way.

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[92] S 31.

[93] AS Butler & DJ Flinn "What is the least that we can expect of a trustee? Exclusion of trustee duties and exemption of trustee liability" (2010) *NZLR* 459 464.

[94] Kelly et al *Law of Trusts* 553.

[95] New Zealand Law Commission *Preferred Approach* 105.

[96] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 78.

[97] New Zealand Law Commission *Preferred Approach* 107.

[98] 105.

[99] New Zealand Law Commission *A Trusts Act for New Zealand* 29.

[100] New Zealand Law Commission *Preferred Approach* 107.

Section 67 and section 68 of the Trusts Act 2019 reflect the recommendations of the Law Commission relating to the appointment of investment managers. Section 67(1) provides that trustees may:[101]

> "… (a) appoint a person to exercise, on behalf of the trustee, specified functions or powers in relation to the trust; (b) appoint a person to make specified decisions in relation to all or part of the trust property; (c) appoint an eligible person to hold or deal with all or part of the trust property as nominee or custodian and vest all or part of the trust property in that person."

Section 67(2) provides that there are certain powers and functions that may not be delegated. Trustees may not, among other things, delegate decisions on distributions, decisions as to whether payments received should be treated as income or capital, or powers to appoint or remove trustees or beneficiaries.[102]

The Law Commission further recommended that the appointment of investment managers should be subject to legislative safeguards.[103] Based on this recommendation, the Trusts Act 2019 provides the following safeguards: first, it is mandatory for trustees to keep any delegation under review and consider whether they need to intervene at any point;[104] and second, trustees must apply the general duty of care specified in section 29 of the Act in appointing an investment manager.[105]

4 3 Total return investing

A common feature under ordinary law is that income beneficiaries are entitled to income and capital beneficiaries are entitled to capital appreciation.[106] This is referred to as the "traditional distribution rule" in chapter 4.[107] The default provisions of the Trustee Act 1956 (as amended) do not allow trustees to disregard the

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[101] S 67(1) of the Trusts Act 2019.

[102] S 67(2).

[103] New Zealand Law Commission *A Trusts Act for New Zealand* 29.

[104] S 68(1) of the Trusts Act 2019.

[105] S 68(2).

[106] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 73-74.

[107] See chapter 4 para 4 4 4.

distinction between capital and income.[108] Trustees cannot, for example, distribute part of a trust's capital return to income beneficiaries. In its report, the Working Party suggested that it might be desirable for trustees to be given wider powers of distributing receipts (whether income or capital) among beneficiaries. However, the Trustee Amendment Act 1988 did not make any alterations to the traditional distribution rule.[109]

Another important aspect of trustees' investment obligation is the duty of impartiality.[110] This duty, preserved by section 13F of the Trustee Act 1956 (as amended), requires trustees to act impartially between the interests of different classes of beneficiaries.[111] In other words, trustees must be even-handed as between income and capital beneficiaries.[112]

The traditional distribution rule, read together with the duty of impartially, means that trustees must invest with a view to balancing a trust's capital and income returns; they cannot invest entirely for capital growth, nor can they invest entirely for income return.[113]

According to the Law Commission, the traditional distribution rule and the duty of impartiality, when taken together, limit the ability of trustees to apply principles of MPT.[114] The Law Commission observed that, if trustees are free from the requirement to select investments with regard to the legal category of the returns received, they would be able to maximise the benefits able to be conferred on beneficiaries.[115] Investing in such a way is known as total return investing.[116] Total return investing enables trustees to do what non-trustee investors do, which is to invest for overall maximum total return.[117] The Law Commission recommended that trustees should be free to decide to invest on a total return basis.[118]

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[108] New Zealand Law Commission *Preferred Approach* 95.

[109] Butler (1995) *Bond LR* 145-146.

[110] *Re Mulligan (deceased)* (1998) 1 NZLR 481 501.

[111] New Zealand Law Commission *A Trusts Act for New Zealand* 134.

[112] *Re Mulligan (deceased)* (1998) 1 NZLR 481 501.

[113] New Zealand Law Commission *A Trusts Act for New Zealand* 135.

[114] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 73.

[115] New Zealand Law Commission *A Trusts Act for New Zealand* 135.

[116] The Law Commission *Capital and Income in Trusts* 34; see also chapter 4 para 4 4 4.

[117] New Zealand Law Commission *A Trusts Act for New Zealand* 134-135.

[118] 134.

The Law Commission considered two options of how legislation could facilitate total return investment. The first option was the "percentage trust" model. Under this model, trust assets are valued on a periodic basis and a percentage of that value is distributed to income beneficiaries.[119] The duty of impartiality continues to apply since income beneficiaries must receive a fair rate of return as measured by some external benchmark.[120]

The second option that was considered can be referred to as the "power of allocation".[121] The power to allocate provides trustees with a discretion to determine whether a return is to be treated as income or capital for the purposes of distribution.[122] Trustees are thus allowed to invest for total overall growth and then make a reasonable determination as to what portion should be distributed as income.[123] The power to allocate is subject to certain safeguards, including the duty to be impartial and the duty to act in the best interests of the beneficiaries.[124]

Of the two options available for a total return investment approach, the Law Commission recommended the power of allocation.[125]

The Trusts Act 2019 reflects the recommendation of the Law Commission as it contains the following section:[126]

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[119] 135.

[120] British Columbia Law Institute *Total Return Investing by Trustees* (2001) Report 16 7.

[121] Strictly speaking, the power that the Law Commission recommended was the "power to determine". The wording of the "power to determine" differs slightly from the "power to allocate". For the purposes of distribution, the power to determine requires trustees to make a reasonable decision as to what capital and income are, while the power to allocate permits trustees to allocate returns to either income beneficiaries or capital beneficiaries in the trustees' discretion. However, from a distributional point of view, there is not a significant difference between these two powers. Accordingly, when referring to the recommendation of the Law Commission, reference is made to the power of allocation and not the power to determine: see New Zealand Law Commission *Preferred Approach* 96-97 and RW Nenno "The power to adjust and total-return unitrust statutes: state developments and tax considerations" (2008) 42 *Real Prop Prob & Tr J 657* 667.

[122] New Zealand Law Commission *A Trusts Act for New Zealand* 28.

[123] New Zealand Law Commission *Preferred Approach* 96.

[124] 98.

[125] New Zealand Law Commission *A Trusts Act for New Zealand* 135.

[126] S 60 of the Trusts Act 2019.

"For the purposes of distribution, and of preparing and completing a financial statement for a trust, a trustee may determine whether a return on an investment is to be treated as income or capital."

As discussed in chapter 5, the English Law Commission is of the view that for any model of total return investing to be successful, tax law has to be reformed.[127] The New Zealand Law Commission, however, reached a different conclusion. In the Law Commission's opinion, it is possible to implement the power to allocate without having to make any changes to tax law:[128]

"The discretion of trustees to decide what is to be treated as income or capital is for the purposes of trust law and does not in any way alter or override the definitions and application of the revenue statutes, for the purposes of taxation."

4 4 Abolishment of the anti-netting rule

In its 1986 report, the Working Party recommended that the anti-netting rule be abolished. As a result, section 13Q of the Trustee Act 1956 (as amended) was introduced, which is designed to overcome the effect of the rule.[129] Admittedly, the rigour of the rule has been mitigated to some extent by the section. The section allows for set-off at the discretion of the court, and the discretion to set off is activated where the court "thinks just".[130] However, there is some uncertainty as to whether the rule has indeed been abolished successfully. Butler states that the problem is that section 13Q fails to describe the circumstances in which it will be just to relieve trustees of liability for losses suffered by an individually imprudent investment.[131]

According to the Law Commission, the anti-netting is in conflict with MPT.[132] Accordingly, to avoid any doubt, it recommended that future legislation should expressly clarify that the rule is abolished.[133] Section 55 of the Trusts Bill 2016 gave

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[127] See chapter 5 para 5 5.

[128] New Zealand Law Commission *A Trusts Act for New Zealand* 134.

[129] See para 3 4 above.

[130] S 13Q of the Trust Act 1956 (as amended).

[131] Butler (1995) *Bond LR* 143.

[132] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 73. The different views on the compatibility of the anti-netting rule with MPT are discussed in chapter 7 para 7 2 4.

[133] New Zealand Law Commission *A Trusts Act for New Zealand* 131.

effect to the Law Commission's recommendation. Two subsections were of particular relevance: first, the intention of section 55(2) was to re-enact section 13Q, but without the "court may set off, as it thinks just" part;[134] and second, section 55(4) was intended to expressly abolish what was referred to as "the anti-netting rule":[135]

> "The rule of law that requires the assessment of the decisions of a trustee on an investment-by-investment basis if the decisions are called into question (known as the anti-netting rule) is taken to have been abolished on 1 October 1988."

Section 55(4) is confusing because the rule of law it referred to was the *isolation approach* and not the *anti-netting rule*.

Section 129 of the Trusts Act 2019, the section in the Act that deals with the anti-netting rule, does not contain a provision similar to section 55(4) of the Trusts Bill 2016. Nevertheless, section 129 of the Trusts Act 2019 signals quite clearly that the anti-netting rule will be abolished once the Act enters into force. Section 129(2) states that:[136]

> "The court may set off all or part of the loss resulting from the investment against all or part of any gain resulting from any other investment whether in breach of trust or not."

5 Is MPT the standard of prudence in New Zealand?

This section raises the following important question: has trust investment law in New Zealand moved from *permitting* the use of MPT to perhaps *requiring* investment in accordance with MPT? The answer to the question is important because, if it is determined that trustees have an obligation to make investment decisions in line with the tenets of MPT, not doing so would amount to imprudent behaviour.

In 1986, the Working Party did not yet believe that it was correct to hold all trustees to MPT techniques:[137]

> "[W]e do not suggest that every fund manager must embark on a scheme of portfolio management, irrespective of the size and the particular needs of the fund concerned. Nor

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[134] S 55(2) of the Trusts Bill.

[135] S 55(4).

[136] S 129(2) of the Trusts Act 2019.

[137] Butler (1995) *Bond LR* 149.

do we assert that techniques of portfolio management have as yet been as extensively developed in New Zealand as appears to have been the case in the USA …"

However, the Working Party went on to state that this might change in the near future:[138]

"… though we have no reason to doubt that the necessary expertise is becoming more readily available here, and that market forces would soon encourage financial institutions and other qualified persons to provide such services to trustees if portfolio management strategies were to become an accepted or required aspect of trustee investment practices."

It appears that the Working Party took the view that it was highly likely that the use of MPT techniques would become an accepted (or perhaps required) feature of trustee investment practices. Consequently, the Working Party recommended changes to legislation that would facilitate MPT-based trust investing.[139]

In his 1995 article, Butler states that New Zealand's financial services sector has rapidly grown more sophisticated since 1986 – the date that the Working Party published its report.[140] Moreover, he states that MPT has established itself as an "orthodox theory of investment management with successful wide-spread application",[141] thus confirming what the Working Party had anticipated. In light of these developments, Butler spends some time determining whether the Trustee Act 1956 (as amended) permits, encourages, or mandates the use of MPT. Butler concludes that the Act encourages the use of MPT for all trusts, and mandates the use thereof for professional trustees.[142]

Since Butler's 1995 article, a High Court decision has widened MPT's application. According to Manns, the *Re Mulligan (deceased)*[143] ("*Mulligan*") decision has essentially ruled that all trustees are required to use MPT techniques.[144] Another academic, Getzler, shares this view. He states that *Mulligan* is a striking decision

[138] 149.
[139] See para 3 above.
[140] Butler (1995) *Bond LR* 149.
[141] 150.
[142] 150; Manns (1998) *Victoria U Wellington LR* 613.
[143] (1998) 1 NZLR 481.
[144] Manns (1998) *Victoria U Wellington LR* 612; see also Kelly et al *Law of Trusts* 604.

that goes beyond *Nestle*, the well-known English trust law case.[145] In *Nestle*, the Court of Appeal of England was prepared to state that the use of MPT may be permitted. In contrast, in *Mulligan*, the New Zealand High Court was prepared to make MPT the new standard of prudence.[146]

The facts of the *Mulligan* case were as follows: Mr Mulligan died in 1949 and left his widow, Mrs Mulligan, a substantial sum of money and a life interest in a trust.[147] The capital of the trust was to pass to Mr Mulligan's nephews and nieces on Mrs Mulligan's death.[148] The trustees of the trust were Mrs Mulligan and a trustee corporation, namely PGG Trust Limited ("PGG").[149]

Financial investment by the trust began in 1965.[150] The major asset of the trust, a farm, was sold and the balance of the trust stood at about $108 000. The trustees, Mrs Mulligan and PGG, invested entirely in fixed-income securities.[151] As a result Mrs Mulligan, as income beneficiary, enjoyed a good income.[152] The investment favoured her, but at the expense of the capital beneficiaries:[153]

> "Investing in fixed-income securities cheats the remainder beneficiaries because the principal amount of the debt, the thing to which the remainder beneficiaries are entitled, remains constant while inflation whittles away its purchasing power."

PGG's employees' own testimony showed that they had recognised the risk of inflation and that they were well aware of the need to diversify.[154] Moreover, their testimony established the industry practice of investing in equities to combat inflation. In evidence it was revealed that between 1965 and 1990 PGG tried to persuade its co-trustee, Mrs Mulligan, to invest in equities so as to counter

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[145] JS Getzler "Fiduciary investment in the shadow of financial crisis: was Lord Eldon right?" (2009) 3 *J Eq* 75-76.

[146] 75-76.

[147] G Watt *Trusts and Equity* 4 ed (2008) 420-421.

[148] Kelly et al *Law of Trusts* 605.

[149] Manns (1998) *Victoria U Wellington LR* 615.

[150] 615.

[151] Watt *Trusts and Equity* 421.

[152] *Re Mulligan (deceased)* (1998) 1 NZLR 481 483.

[153] Manns (1998) *Victoria U Wellington LR* 615 footnote 19.

[154] PG Willoughby "International trusts under fire: the increasing scope for litigation: part 3" (1997) 2 *PCB* 76 80; Manns (1998) *Victoria U Wellington LR* 615-616.

inflation.[155] However, Mrs Mulligan adamantly refused any change in investment policy.[156] Ultimately, PGG deferred to Mrs Mulligan's demand that the trust capital remains solely invested in fixed-income investments.[157] Yet, ironically, Mrs Mulligan was a skilled investor who at her death owned an extensive share portfolio.[158]

Mrs Mulligan died 25 years after the trust began investing and left her estate of $686 000 to relatives on her side of the family.[159] By contrast, the capital of the trust stood at a little under $102 000. While the nominal value of the capital of the trust was largely preserved ($108 000 in 1965 compared with $102 000 in 1990), inflation in New Zealand between 1965 and 1990 was substantial.[160] The inflation equivalent value of $108 000 in 1965 was $1 368 000 at the time of trial. According to expert evidence on behalf of the capital beneficiaries, $108 000 could have bought fourteen average residential properties in Christchurch in 1965, but by 1990 it was not even enough to buy one such a property.[161]

The capital beneficiaries – the nephews and nieces of Mr Mulligan – sued both PGG and Mrs Mulligan for breach of trust on the basis that investing in fixed-interest securities rather than shares did not treat the income and capital beneficiaries impartially.[162] The trustees denied breach of trust and raised section 73 of the Trustee Act 1956 (as amended) (the section provides that a trustee acting honestly and reasonably could be excused for breach of trust). The trustees also sought indemnities from each other.[163]

Panckhurst J held that a trustee had to be strictly impartial between income and capital beneficiaries in the circumstances of the case. PGG was in breach of trust because it had appreciated the corrosive harm of inflation on the trust capital, but had nevertheless deferred to Mrs Mulligan's wishes. PGG either should have persuaded Mrs Mulligan to invest in shares or, failing that, filed a court action

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[155] Watt *Trusts and Equity* 421.

[156] Kelly et al *Law of Trusts* 606.

[157] Watt *Trusts and Equity* 421.

[158] *Re Mulligan (deceased)* (1998) 1 NZLR 481 499; Manns (1998) *Victoria U Wellington LR* 616 footnote 21.

[159] *Re Mulligan (deceased)* (1998) 1 NZLR 481 499; Cone (2013) *T & T* 718.

[160] Manns (1998) *Victoria U Wellington LR* 615.

[161] *Re Mulligan (deceased)* (1998) 1 NZLR 481 483.

[162] 481 and 483.

[163] 481.

seeking direction. Panckhurst J further held that the trustees could not rely on section 73. PGG did nothing adequate to persuade Mrs Mulligan to invest in shares and did not seek the court's directions. Furthermore, Mrs Mulligan did not act reasonably in her capacity as trustee as she understood the wisdom of investing in shares, yet she was hostile to diversification of the trust capital.[164] Regarding the measurement of damages, Panckhurst J found that by 1972 a prudent trustee would have invested 40% of the trust fund in equities.[165] On that basis, and making all the usual allowances for contingencies, the trustees' failure to diversify into equities had resulted in a loss of $170 640.[166]

Ultimately, both PGG and Mrs Mulligan were at fault and therefore jointly and severally liable to the capital beneficiaries for breach of trust and not entitled to an indemnity from another trustee.[167] In the case of Mrs Mulligan, the liability to make restitution fell on her estate.[168]

Mulligan thus shows that where trustees allow a trust fund to reduce in value by failing to use MPT techniques, they can be sued for breach of trust and will be ordered to make good any loss than can be proved.

To summarise the position in New Zealand regarding the use of MPT, all trustees (including ordinary New Zealanders who become trustees or professional trustees) are required to invest in accordance with MPT unless the trust instrument states that the use of MPT techniques should be avoided – either totally or in part.[169]

It is submitted that this position will not change once the Trusts Act 2019 enters into force. None of the changes that the Act will make in the area of trustee investing suggest a movement away from MPT-based trust investing. On the contrary, the purpose of these changes is to better facilitate the use of MPT techniques when investing trust funds.

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[164] 481-482.

[165] 482; Mowbray et al *Lewin on Trusts* 1576.

[166] *Re Mulligan (deceased)* (1998) 1 NZLR 481 512; T Molloy "I am a trustee. I can't make head or tail of (algorithm). Am I at risk?" (2009) 15 *T & T* 524 560.

[167] *Re Mulligan (deceased)* (1998) 1 NZLR 481 482.

[168] 512.

[169] Kelly et al *Law of Trusts* 588-589.

6 Conclusion

Prior to the enactment of the 1988 reforms, trustee investing in New Zealand trust law was based on the legal list approach. The trust instrument could allow for a wider range of investments, but if it did not, trustees were effectively prevented from following a MPT approach to investing. The standard of care expected of trustees was to take such care as ordinary prudent men would take if they were minded to make an investment for the benefit of other people for whom they felt morally bound to provide.

The Trustee Amendment Act 1988 abolished the legal list approach and gave trustees wide powers of investment. This was the first of four changes that assisted trustees to invest in accordance with MPT. The Trustee Act 1956 (as amended) also hints at the acceptability of the total portfolio approach, expressly recognises the desirability of diversification, and contains a provision that is designed to overcome the effect of the anti-netting rule. The standard of care required of trustees remains basically the same as before 1988 – trustees must exercise the care, diligence and skill that a prudent businessperson would exercise in the management of another's affairs – except that an even higher standard is imposed on professionals who are employed to manage trusts.

There were two reasons why reform had to take place in New Zealand in 1988: first, to counter the depreciatory effect of inflation on trust capital; and second, because the Working Party anticipated that the use of MPT techniques would become an accepted feature of trustee investment practices.

The Law Commission concluded in its 2013 report that the 1988 amendments do not go far enough in permitting trustees to adopt the full MPT approach. The Law Commission identified four areas of trustee investing that pose particular difficulties to the adoption of the full MPT approach and recommended the following changes in these areas: first, future legislation should require trustees to follow the total portfolio approach; second, legislation should allow trustees to appoint investment managers with the authority to make investment decisions; third, trustees should be allowed to invest on a total return basis; and fourth, legislation should expressly abolish the anti-netting rule. The Trusts Act 2019 reflects all of these recommendations.

Regarding the question whether trust investment law permits or requires the use of MPT, the chapter established that trustees are *required* to invest in accordance with MPT. This position will remain the same once the Act comes into force. In New Zealand, therefore, unless a contrary intention is expressed in the trust instrument, trustees have an obligation to make investment decisions in line with the tenets of MPT and not doing so would amount to imprudent behaviour.

In summary, similar to New York and England, New Zealand has modernised its trust investment law by adopting an investment rule based on MPT. The next chapter compares and analyses the approaches taken in each of these jurisdictions with respect to the six areas of trustee investment that are most prominently affected by the integration of MPT principles into trust law. The purpose of the next chapter is to formulate an investment rule based on MPT that is fit for the South African trust law context.

CHAPTER 7 – THE INTEGRATION OF MPT PRINCIPLES INTO SOUTH AFRICAN TRUST LAW

1 Introduction

As indicated in chapter 2 ("The development of trustees' investment standards in South Africa"), trustees in South Africa are not judged by an investment rule based on modern portfolio theory ("MPT"). Chapter 2 further establishes that trustees in South Africa are obliged to protect the real value of trust capital and ensure that adequate income is produced continuously. Chapters 4 to 6 reveal that what is expected from trustees in this instance corresponds with the goals embodied in a rule based on MPT.

Chapter 4 ("The development of trustees' investment standards in New York"), chapter 5 ("The development of trustees' investment standards in England") and chapter 6 ("The development of trustees' investment standards in New Zealand") show why trustees subject to a traditional approach to trustee investing will find it exceedingly difficult – if not impossible – to meet this goal without being able to rely on a rule based on MPT. Hence, New York, England and New Zealand had to change their respective trust investment laws in order to meet this challenge.

Chapter 3 ("Modern portfolio theory") argues that MPT presents a better account of risk and safety than other popular models of investment behaviour. Chapter 3 further states that MPT is the best possible investment strategy for people managing other people's assets. Chapters 4 to 6 confirm what is stated in chapter 3 by demonstrating the benefits of using MPT strategies when investing trust funds.

The main research questions posed for purpose of this dissertation are: first, should trustees' investment functions in South African law be modernised through the implementation of an investment rule based on MPT? Second, if the answer to the first question is yes, what should the core features of such an investment rule be? The conclusion reached after the discussion in chapters 3 to 6 is that the first research question should be answered in the affirmative: trust investment law in South Africa should be modernised by integrating MPT principles into trust law.

The purpose of this chapter is to answer the second research question by identifying and explaining the core features of an investment rule based on MPT. Chapters 4 to 6 reveal that the integration of MPT principles into trust law affects many areas of trustee investment; however, six particular areas are affected most prominently, namely, trustees' choice of investments; the evaluation of a trust's investment portfolio; diversification of trust assets; delegation of investment functions; the traditional capital and income allocation rules; and the balancing of gains against losses. This chapter reviews, compares and analyses the approaches taken in each of the comparable foreign jurisdictions with respect to each of the six areas, and formulates an investment rule based on MPT that is fit for the South African trust law context.

Following this introduction, the chapter is divided into six sections, each section discussing one of the six areas affected by the implementation of MPT.

2 Trustees' choice of investments

2 1 Introduction

The purpose of this section is to discuss the first area that is affected by the implementation of MPT, namely trustees' choice of investments. The section starts by sketching the problem that trustees face when the range of investment options open to them remains restricted. It then briefly reviews how each of the comparable foreign jurisdictions has widened trustees' choice of investments. Next, the possible concern that might be raised with allowing trustees to invest in any type of investment is addressed. The section concludes with a summary of the discussion, which is accompanied by a proposal of how legislation should change in order to accommodate the implementation of MPT.

2 2 The weakness of the current approach

One of the tenets of MPT is that no asset or investment technique is regarded as inherently good or bad, or prohibited *per se* as being too risky. The basis for this tenet is the finding of MPT that it is possible to reduce a portfolio's risk in appropriate circumstances by adding an investment that is risky in itself.[1] Integrating this principle of MPT into trust law requires trustees having wide powers of investment as opposed to trustees being limited to narrow categories of investment or trustees

[1] MD Begleiter "Does the prudent investor need the Uniform Prudent Investor Act – an empirical study of trust investment practices" (1999) 51 *Maine LR* 27 35 and 60; JH Langbein "The Uniform Prudent Investor Act and the future of trust investing" (1996) 81 *Iowa LR* 641 649.

being prohibited from investing in speculative investments.[2] From the foregoing it follows that in order to conform to MPT, an investment rule based on MPT has to permit trustees to hold any investment and to use any investment technique.[3] A good example of such a rule is the prudent investor rule of the Restatement (Third).[4] This rule expresses no preconceptions about the suitability of a particular investment vehicle for trust investment purposes.[5]

In South African trust law, not all assets are in principle open to consideration for trustee investment. The rule that governs how trustees should exercise their investment functions is the prudent and careful person rule.[6] In terms of the rule, if trustees receive investments that are speculative, they should sell the investments and reinvest the proceeds in safer investments.[7] This element of the rule – the duty to avoid speculative investments – was confirmed by Scott JA in *Administrators, Estate Richards v Nichol*[8] ("*Estate Richards*"):[9]

> "He [a trustee] will accordingly avoid investments which are of a speculative nature."

In this respect, the prudent and careful person rule resembles a particular version of the prudent man rule, namely "Scott's prudent man rule". What was ordinarily understood as the "prudent man rule" in the United States from 1940 to 1992 was in fact the "traditional prudent man rule"[10] as influenced by the work of Professor Austin W Scott (referred to in chapter 4 as "Scott").[11] Scott's work has played a pivotal role in the legal understanding of trustees' investment functions in the United States.[12] Under Scott's prudent man rule, unless specifically authorised by the governing

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[2] LOC Chukwu "Theoretical underpinnings of trust investment law: juxtaposing Nigerian law with current trends in other Common Law jurisdictions" (2017) 22 *Ann Surv Int'l & Comp L* 73 110.

[3] Begleiter (1999) *Maine LR* 60.

[4] For a discussion of the prudent investor rule of the Restatement (Third), see chapter 4 para 4 5 1.

[5] PJ Ruce "The trustee and the prudent investor: the emerging acceptance of alternative investments as the new fiduciary standard" (2012) 53 *South Texas LR* 653 655 and 689.

[6] For a discussion of the prudent and careful person rule, see chapter 2 para 2 3.

[7] *Ex parte Knight and others* 1946 CPD 800 814.

[8] 1999 1 SA 551 (SCA).

[9] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 558H-I.

[10] Formulated in *Harvard College v Amory* 26 Mass (9 Pick) 446 (1830).

[11] B Longstreth *Modern Investment Management and the Prudent Man Rule* (1986) 39.

[12] For a discussion of Scott's influence on trustees' investment functions in the United States, see chapter 4 para 3.

instrument, any speculative investment was a breach of trust.[13] Forbidden investments under the rule included, among other things, margin purchases of securities, speculative stock, discount bonds, securities in new and untried enterprises, and second mortgages. Speculative stock referred to all companies except those "with regular earnings and paying regular dividends which may reasonably be expected to continue". Shares in companies that did not pay dividends (what might be called "growth stocks") were thus considered to be speculative investments.[14]

Both the prudent and careful person rule and Scott's prudent man rule thus prohibit speculative investments. However, the *Estate Richards* judgment does not provide a definition of speculative investments (nor do any of the cases discussed in chapter 2). This lack of a formal definition might coincide with a "you will know it when you see it" mentality.

Scott's prudent man rule's ban of speculative investments discouraged trustees to use new investment vehicles and techniques regularly favoured by prudent investors.[15] In particular, trustees were unwilling to use alternative investments and derivatives because of the likelihood that a Scott-influenced court would regard such investments as being speculative.[16] This occurred despite the fact that alternative investments permit greater diversification across the investment spectrum,[17] while derivatives can add significantly to the stability and long-term prospects of a portfolio.[18]

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[13] PG Haskell "The prudent person rule for trustee investment and modern portfolio theory" (1990) 69 *North Carolina LR* 87 94; WB Phillips "Chasing down the devil: standards of prudent investment under the Restatement (Third) of Trusts" (1997) 54 *Wash & Lee LR* 335 345.

[14] JN Gordon "The puzzling persistence of the constrained prudent man rule" (1987) 62 *N Y U LR* 52 61; Ruce (2012) *South Texas LR* 662.

[15] Gordon (1987) *N Y U LR* 52-53; RD Blair & AA Heggestad "The prudent man rule and preservation of trust principle" (1978) 1 *L F* 79 94.

[16] Gordon (1987) *N Y U LR* 61-62; Haskell (1990) *North Carolina LR* 90-91.

[17] Gordon (1987) *N Y U LR* 53; Blair & Heggestad (1978) *Law Forum* 94-95.

[18] Gordon (1987) *N Y U LR* 53; AS Butler "Modern portfolio theory and investment power of trustees: the New Zealand experience" (1995) 7 *Bond LR* 119 129.

2 2 1 The benefits of adding alternative investments to a portfolio

Alternative investments are "investments other than traditional investments in fixed income and publicly traded equity securities".[19] These investments include hedge funds, private equity, commodities and collectables.[20] A hedge fund can be described as an investment structure that pools capital from a number of investors and then employs several different strategies to earn a return for its investors.[21] Some of the strategies that hedge funds employ include using derivatives, leverage and short-selling.[22] Private equity on the other hand is "a managed investment pool that typically makes long-term investments in private companies with the aim of obtaining a controlling interest and increasing the value of the companies through management and improved operations or innovation".[23] The benefit of combining alternative investments with a traditional portfolio of equities is that, because alternative investments often have low correlations with such a portfolio, allocating an exposure to it can be a good diversifier.[24]

The latest alternative investment on the scene is *cryptocurrency.* The South African Revenue Service ("SARS") identifies cryptocurrency (typified by bitcoin) as "an internet-based digital currency that exists almost wholly in the virtual realm".[25] The invention of bitcoin by Satoshi Nakamoto in 2008 spurred the creation of many new cryptocurrencies.[26] Lee and others studied the co-movement between traditional asset classes and the cryptocurrency index, namely, CRIX. Their results are quite surprising. They observed that cryptocurrency as an asset class is a good diversifier in a traditional portfolio.[27] However, they caution that cryptocurrency is still at the

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[19] Ruce (2012) *South Texas LR* 656.

[20] 656; DKC Lee, L Guo & Y Wang "Cryptocurrency: a new investment opportunity?" (2018) 20 *J Altern Invest* 16 20-21.

[21] B Goodall *Investment Planning* (2017) para 9.2.

[22] Y Chen "Derivatives use and risk taking: evidence from the hedge fund industry" (2011) 46 *J Finan Quant Anal* 1073 1074 and 1104.

[23] Ruce (2012) *South Texas LR* 659.

[24] 657-658.

[25] Anonymous "SARS's stance on the tax treatment of cryptocurrencies" (06-04-2018) *Media Releases* <http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx> (accessed 12-03-2019).

[26] Lee et al (2018) *J Altern Invest* 16.

[27] 17.

experimental stage and that there are many issues that need to be addressed before it should be considered as an asset class of great interest to institutions.[28]

2 2 2 The benefits of using derivatives

A derivative is a financial instrument, or contract, between two parties that derives its value from some other underlying asset. The underlying asset is often a financial security such as a stock, but it can also be any asset that the contracting parties are interested in trading.[29] Common underlying assets include bonds, commodities, currencies, and market indexes. Examples of derivatives are forwards, futures, options, and swaps.[30] According to Aalberts and Poon, futures and options are the two types of derivative that are the most suitable candidates for trustees to use in implementing trust hedging strategies.[31] Futures refers to futures contracts, a type of derivative in which a party contracts for exchange of a specific asset at a future date.[32] An option is a contract that gives the holder or owner of an option the right, but not the obligation, to buy or sell an underlying instrument at a predetermined price during a specific period or at a specific time.[33]

The benefit of futures and options is that trustees can use them to hedge the risk of trust investments. The future price of an investment can, for example, be predetermined in a derivative contract, thereby reducing the uncertainty of the future price of the investment.[34] Indeed, the appropriate use of futures and options may provide, at much lower cost (especially in light of tax considerations),[35] the same economic protection as converting to a more conservative portfolio of assets.[36]

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[28] 33.

[29] RJ Aalberts & PS Poon "Derivatives and the modern prudent investor rule: too risky or too necessary?" (2006) 67 *Ohio St LJ* 525 545.

[30] SM Penner "International investment and the prudent investor rule: the trustee's duty to consider international investment vehicles" (1995) 16 *Michigan J Int'l L* 601 617; Aalberts & Poon (2006) *Ohio St LJ* 546.

[31] Aalberts & Poon (2006) *Ohio St LJ* 558.

[32] 534 footnote 45.

[33] B van den Berg *Understanding Financial Markets and Instruments* 6 ed (2008) 149.

[34] Aalberts & Poon (2006) *Ohio St LJ* 546; SE Sterk "Rethinking trust law reform: how prudent is modern prudent investor doctrine" (2010) 95 *Cornell LR* 851 896.

[35] JE Penner *The Law of Trusts* 6 ed (2008) 274-275.

[36] HE Bines "Modern portfolio theory and investment management law: refinement of legal doctrine" (1976) 76 *Columbia LR* 721 769; RH Borkus "A trust fiduciary's duty to implement capital preservation

2 2 3 Conclusion

In conclusion, the weakness of an investment rule that prohibits speculative investments, such as the prudent and careful person rule and Scott's prudent person rule, is that it prevents trustees from using investment vehicles and techniques that permit greater diversification across the investment spectrum and provide economic protection at a lower cost than conventional methods.

2 3 The approach in each of the comparable foreign jurisdictions

The respective legislative advisory committees and legal commissions in New York, England and New Zealand brought the advantages of the implementation of MPT under the attention of the legislatures in the different jurisdictions. Eventually, these legislatures responded by amending the statutes dealing with the investment of trust funds to reflect the new knowledge.

The New York State Legislature enacted the Prudent Investor Act on 1 January 1995.[37] The Prudent Investor Act codifies a prudent investor rule for New York, thereby replacing New York's prudent man rule. The new rule is referred to in chapter 4 as New York's prudent investor rule.[38] Whereas the old prudent man rule warned trustees to avoid speculative investments, New York's prudent investor rule authorises trustees to:[39]

> "… invest in any type of investment consistent with the requirements of this paragraph, since no particular investment is inherently prudent or imprudent for purposes of the prudent investor standard …"

In England, in response to the criticisms of the Trustee Investments Act 1961, section 3 of the Trustee Act 2000 confers the widest possible investment powers on trustees:[40]

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strategies using financial derivative techniques" (2001) 36 *Real Prop Prob & Tr J* 127 157 footnote 159.

[37] Radigan "Advisory Committee: Prudent Investor Act" (05-09-2010) *Ruskin Moscou Faltischek* <http://www.rmfpc.com/advisory-committee-prudent-investor-act/> (accessed 04-11-2016) 2; S 11-2.3(a) of the Prudent Investor Act.

[38] For a discussion of New York's prudent investor rule, see chapter 4 para 5.

[39] S 11-2.3(b)(4)(A) of the Prudent Investor Act.

[40] S 3(1) of the Trustee Act 2000.

> "... a trustee may make any kind of investment that he could make if he were absolutely entitled to the assets of the trust."

Before 1 February 2001, the date that the Trustee Act 2000 came into force,[41] trust funds were divided into two categories known as narrower-range and wider-range categories. The narrower-range category was available for investment in narrower-range investments and the wider-range one was available for investment in narrower-range or wider-range investments.[42] The definition of wider-range investments was quite restrictive. It permitted trustees to invest only in shares that meet certain qualifying conditions.[43] A practical result of the requirement to meet certain conditions was that trustees could not invest in many well-known companies.[44] According to Watt, the primary obstacle to implementing MPT in England was the fact that trustee investment was limited to only certain types of investment. Watt confirms that the Act has successfully removed this obstacle.[45]

In New Zealand, the Trustee Amendment Act 1988 eliminated the old legal approach and replaced it with a provision that empowers trustees to "invest any trust funds, whether at the time in a state of investment or not, in any property".[46] The new provision encourages those trustees who would like to pursue a MPT approach since "no pre-conceptions are expressed about the suitability of a particular investment vehicle for trust investment purposes".[47] The word "property" is defined in section 2 of the Trustee Act 1956 (as amended). Property includes: "real and personal property, and any estate, share, and interest in any property, real or personal, and any debt, and any thing in action, and any other right or interest, whether in possession or not".[48] According to Kelly and others, the term includes "futures and

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[41] J Mowbray, L Tucker, N le Poidevin, E Simpson & J Brightwell *Lewin on Trusts* 18 ed (2008) 1023.

[42] 1271; The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* (1999) Law Com No 260 and Scot Law Com No 172 13-14. For a discussion of trust investment law in England before 1 February 2001, see chapter 5 para 2 and 3.

[43] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 16-17.

[44] G Watt *Trusts and Equity* 4 ed (2008) 411-412.

[45] 411.

[46] S 13A(1) of the Trustee Act 1956 (as amended); G Cone "Sharing away trustees powers – New Zealand" (2013) 19 *T & T* 712 718.

[47] Butler (1995) *Bond LR* 143.

[48] S 2 of the Trustee Act 1956 (as amended).

hedge contracts and the like", which differs significantly from the cautious approach that was taken before 1988.[49]

It is worth mentioning that the Trusts Act 2019 (entering into force on 30 January 2021) reaffirms the power to invest in any asset:[50]

> "A trustee may invest trust property in any property."

2 4 The concern with wide powers of investment

One might raise the concern that allowing trustees to invest in any type of asset would lead to future trust portfolios only being filled with exceptionally risky assets.[51] In other words, the objection can be raised that trustees might exploit their wide investment powers by ignoring the hazardous nature of individual investments and investing in any enterprise that they deem profitable. This is a perfectly legitimate concern if there is nothing to act as a counterbalance to wide investment powers. Therefore, to balance the introduction of wide investment powers, it is recommended that legislation should contain two safeguards to regulate investment selection and ongoing investment management responsibilities.

First, any form of investment should only be permissible provided that proper care, diligence and skill are employed.[52] Consider, for example, the approaches developed in the comparable foreign jurisdictions. New York's prudent investor rule requires trustees to act as prudent investors would and exercise reasonable care, skill and caution when making and implementing investment decisions.[53] In England, trustees are subject to a statutory duty of care when exercising their powers of investment:[54]

> "Whenever the duty under this subsection applies to a trustee, he must exercise such care and skill as is reasonable in the circumstances ..."

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[49] NC Kelly, C Kelly & G Kelly *Garrow and Kelly Law of Trusts and Trustees* 6 ed (2005) 585.

[50] S 58 of the Trusts Act 2019.

[51] Langbein (1996) *Iowa LR* 650: "Should we expect to see future trust portfolios stuffed with penny stocks, Polish zloty futures, and Czarist Russian bonds?".

[52] JD Heydon "Modern fiduciary liability: the sick man of equity?" (2014) 20 *T & T* 1 9.

[53] S 11-2.3(b)(2) of the Prudent Investor Act.

[54] S 1(1) of the Trustee Act 2000.

According to section 13B of New Zealand's, when exercising any power of investment, a trustee must "exercise the care, diligence and skill that a prudent businessperson would exercise in the management of another's affairs".[55]

Broadly speaking, the duty to act with care, diligence and skill requires trustees to: invest only with reputable companies that have performed, and continue to perform, relatively well as fund managers;[56] make a reasonable effort to verify facts relevant to the investment and management of trust assets;[57] and only incur management and transaction costs that are appropriate and reasonable in relation to the assets and the purposes of the trust.[58]

Second, trustees are given greater flexibility in choosing investments provided that the overall investment plan is prudent and that any additional investments advance the overall investment plan. Two questions arise from this second safeguard: when is an investment plan regarded as prudent, and when can it be said that an investment has advanced the overall investment plan? With regard to the first question, a trust's overall investment plan is viewed as prudent if trustees invest at a level of risk-and-return that is suitable for the particular trust. In order to determine what would be regarded as a *suitable* level of risk-and-return, trustees will have to consider the prevailing circumstances.[59] As discussed in chapter 2, circumstances can be divided into specific and general circumstances.[60] The circumstances that trustees have to consider when making investment decisions are discussed later in the chapter.[61]

As to the second question, new investments are viewed as advancing the overall investment plan if these investments are employed in a manner that reduces the

[55] S 13B of the Trustee Act 1956 (as amended). See also s 29 of the Trust Act 2019.

[56] FP Manns "New Zealand trustee investing: reflecting on modern portfolio theory and the ancient distinction of principle and income" (1998) 28 *Victoria U Wellington LR* 611 626.

[57] JI Horn "Prudent investor rule, modern portfolio theory, and private trusts: drafting and administration including the 'give-me-five' unitrust" (1998) 33 *Real Prop Prob & Tr J* 1 59.

[58] 60; EC Halbach "Trust investment law in the Third Restatement" (1992) 27 *Real Prop Prob & Tr J* 407 417.

[59] A Duckworth "Legal aspects of trustee investment – is the prudent man still alive and well? Part 1" (1997) *PCB* 22 30.

[60] See chapter 2 para 4 2.

[61] See para 3 5 below.

overall risk of the trust portfolio, or allow the trust to achieve a higher return expectation without a disproportionate increase in the overall level of portfolio risk.[62]

There is one more point worth discussing regarding the issue concerning wide investment powers. While an investment rule based on MPT allows speculative investments to be included in a trust portfolio, such a rule continues to condemn speculating with trust assets. Speculation can be defined as the act of engaging in any business enterprise or transaction of a venturesome or risky nature that offers the chance of great or unusual gain.[63] With speculation, the risk of loss is more than offset by the possibility of a huge gain; otherwise, there would be very little motivation to speculate. The following investments, taken on their own, might be regarded as constituting speculation: purchasing property for short-term resale;[64] investing in a speculative property development;[65] and using derivatives not with an intention to reduce or eliminate a pre-existing risk, but with an intention to seek profit by willingly accepting increased risk.[66] Speculation should not be confused with gambling. The key difference is that speculation can sometimes involve taking a calculated risk, whereas gambling depends on totally random outcomes or chance. For example, the results of the lottery will be strictly ruled by random chance, and no amount of prudent investigation can alter the results.[67] It goes without saying that trustees are not allowed to gamble with trust funds.[68]

2 5 Conclusion and proposed changes to legislation

The problem in South African trust law with restricting trustees' choice of investments is that it prevents trustees from using investment strategies that are now regularly favoured by jurisdictions such as New York, England and New Zealand. In particular, trustees are inhibited from investing in alternative investments and using

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[62] Radigan (05-09-2010) *Ruskin Moscou Faltischek* <http://www.rmfpc.com/advisory-committee-prudent-investor-act/> (accessed 04-11-2016) 3; CB Schwartzel "Is the prudent investor good for Texas" (2002) 54 *Baylor LR* 701 731-732.

[63] JC Dobris "The probate world at the end of the century: is a new Principle and Income Act in your future?" (1993) 28 *Real Prop Prob & Tr J* 393 445 footnote 17.

[64] Haskell (1990) *North Carolina LR* 91.

[65] G Moffat *Trust Law Text and Materials* 5 ed (2009) 483 and 499.

[66] Aalberts & Poon (2006) *Ohio St LJ* 552-553.

[67] Dobris (1993) *Real Prop Prob & Tr J* 462.

[68] Mowbray et al *Lewin on Trusts* 1284.

derivatives despite alternative investments permitting greater diversification across the investment spectrum and derivatives having the potential to add significantly to the stability and long-term prospects of a trust portfolio.

MPT teaches that no asset or investment technique is regarded as inherently good or bad, or prohibited *per se* as being too risky. Integrating this principle of MPT into South African trust law would require trustees to have wide powers of investment as opposed to them being prohibited from investing in speculative investments.[69] Therefore, it is proposed that our current rule governing trustees' investment functions, namely, the prudent and careful person rule, be replaced with an investment rule based on MPT. Hereafter, this new rule is referred to as "South Africa's prudent investor rule".

An important point to highlight is that South Africa's prudent investor rule will only find application when trustees are exercising their investment functions. The prudent and careful person rule will continue to govern all non-investment related functions. Accordingly, no changes to section 9 of the Trust Property Control Act are proposed, save for the section indicating that it is only applicable to non-investment related functions.

It is proposed that a new section, section 9A, be inserted in the Trust Property Control Act with the heading "The prudent investor rule". Subsection (1) of section 9A codifies and clarifies trustees' standard of care when investing:

> "In performing his investment related functions, a trustee must exercise the care, diligence and skill that a prudent investor would exercise in similar circumstances."

A prudent investor is someone familiar with contemporary practices in the investment industry.[70] Investing in the same manner as a prudent investor would undoubtedly be a difficult task for a trustee with no training in finance or asset management. As discussed in a later section in the chapter, the solution that an investment rule based on MPT offers is not to lower the standard of care for unskilled trustees, but rather to make broad provision for the proper delegation of trustees' investment functions.[71]

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[69] Chukwu (2017) *Ann Surv Int'l & Comp L* 110.

[70] G Crawford "A fiduciary duty to use derivatives?" (1995) 1 *Stanford JL Bus & Fin* 307 327.

[71] See para 5 below.

The wording of subsection (1) is intended to avoid the unnecessary controversy over whether trustees are to invest as persons would in managing *their own funds* or in managing *the funds of others.*[72] The matter seems more usefully stated by requiring trustees to take prevailing circumstances into account. Therefore, it is imperative that subsection (1) be read together with subsection (4), which is discussed in a later section in the chapter.[73] Subsection (4) lists the specific and general circumstances that trustees should consider before making investment decisions.

Subsection (2) of section 9A gives trustees wide powers of investment:

> "A trustee may make any kind of investment consistent with the prudent investment standard."

This provision achieves the objective of declaring all property in principle open to consideration for trustee investment.

The concern that the proposed changes will lead to trustees only investing in exceptionally risky assets are put to rest by having the necessary safeguards in place. First, trustees are subject to a statutory duty of care when exercising their powers of investment. Second, trustees are given greater flexibility in choosing investments provided that the overall investment plan is prudent and that any additional investments advance the overall investment plan. This second safeguard is discussed in detail in the next section.

3 The evaluation of a trust's investment portfolio

3 1 Introduction

The purpose of this section is to discuss the second area affected by the implementation of MPT, namely the evaluation of a trust's investment portfolio. The section starts by discussing the difference between evaluating a trust's investment portfolio using the isolation approach versus the total portfolio approach. The problems associated with the isolation approach are also presented under this heading. Next, it is argued that South African trust law follows the isolation approach to trustee investing. Thereafter, the section briefly reviews how each of the

[72] Halbach (1992) *Real Prop Prob & Tr J* 416 footnote 32.

[73] See paras 3 5 and 3 6 below.

comparable foreign jurisdictions has moved from the isolation approach to the total portfolio approach. Following this discussion, the section describes how the prudence of a trust's overall investment strategy is determined under an investment rule based on MPT, it lists the circumstances that trustees should consider when making investment decisions, and it addresses a possible concern with the acceptance of the total portfolio approach. The section concludes with a summary, which is accompanied by proposals of how legislation should change in order to introduce the total portfolio approach into South African trust law.

3 2 The difference between the isolation approach and the total portfolio approach

One of the most basic tenets of MPT is the maxim that the riskiness of an asset cannot be determined in isolation, but can be usefully determined only within the context of the overall risk of the portfolio to which the asset is added.[74] This means that the true information that an investment manager has to consider when evaluating the desirability of investing in a particular asset is how the asset moves in relation with the other assets in the portfolio.[75] According to MPT, it is possible for a given asset to be quite risky when held in isolation, but not that risky if held in a portfolio.[76] Furthermore, MPT illustrates that it is also possible for an investment manager to use investments that are highly risky when viewed in isolation in order to assemble a portfolio that is safe.[77]

Integrating this principle of MPT into trust law requires trustees' investment decisions to be evaluated – not in isolation, but in the context of the trust's investment portfolio as a whole and as a part of an overall investment strategy.[78] The prudent investor rule of the Restatement (Third) is a good example of an investment rule that is consistent with MPT. The prudent investor rule states that it is to be applied to the entire portfolio rather than to a particular investment or investments

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[74] Penner (1995) *Michigan J Int'l L* 610; Gordon (1987) *N Y U LR* 67.

[75] Penner (1995) *Michigan J Int'l L* 637. To be more specific, the investment manager has to consider the relationship between the rate-of-return pattern of the new asset versus the rate-of-return pattern of each other asset in the portfolio: Levy "The prudent investor rule: theories and evidence" (1994) 1 *Geo Mason U LR* 1 13. Statistically, this measure is known as co-variance. For a discussion of co-variance, see chapter 3 para 3 1 3.

[76] Butler (1995) *Bond LR* 122 footnote 15; Langbein (1996) *Iowa LR* 647.

[77] Gordon (1987) *N Y U LR* 67.

[78] Ruce (2012) *South Texas LR* 680.

viewed in isolation from the overall investment strategy.[79] This approach is referred to as the total portfolio approach.

The total portfolio approach contrasts markedly with an approach that assesses the decisions of trustees on an investment-by-investment basis. For example, the prudent man rule of the Restatement (Second) required trustees to evaluate prudence one investment at a time:[80]

> "… only if each investment is safe, measured in isolation, will the collection of investments (the portfolio) be safe."

This approach is referred to as the isolation approach.

The isolation approach creates the following two problems for trustees: first, judging investments in isolation tends to label broad categories of investments and techniques as speculative and, therefore, as inappropriate investment vehicles for trusts.[81] For example, under the prudent man rule of the Restatement (Second), some of the investments and techniques that were either legally precluded or questionable were the following: certain uses of options and futures, margin purchases of securities, speculative stock, discount bonds, new and untried enterprises, venture capital pools, foreign stocks, and second mortgages.[82]

Second, because the isolation approach concentrates on single investments without looking at the portfolio in its entirety, trustees are required to defend the performance of each individual investment in the portfolio.[83] This practice exposes trustees to liability for a decline in the value of one investment even if that investment is part of a well-diversified portfolio.[84] In the American states that followed the prudent man rule, Scott-influenced courts tended to judge (in retrospect) investments

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[79] Langbein (1996) *Iowa LR* 647 footnote 46; Radigan (05-09-2010) *Ruskin Moscou Faltischek* <http://www.rmfpc.com/advisory-committee-prudent-investor-act/> (accessed 04-11-2016) 3.

[80] Gordon (1987) *N Y U LR* 66-67.

[81] Ruce (2012) *South Texas LR* 664; Halbach (1992) *Real Prop Prob & Tr J* 411.

[82] Gordon (1987) *N Y U LR* 52-53 and 53 footnote 1. Speculative stock referred to all companies except those with regular earnings and paying regular dividends which may reasonably be expected to continue: Ruce (2012) *South Texas LR* 662.

[83] LJ Bobo "Nontraditional investments of fiduciaries: re-examining the prudent investor rule" (1984) 33 *Emory LJ* 1067 1101.

[84] M Kunene "Fiduciaries and their investment decision: a need for change" (2001) September *INS TAX* 1 3-4; Blair & Heggestad (1978) *Law Forum* 88.

that performed poorly as too risky and held trustees liable for losses sustained by the trust fund.[85]

3 3 The approach in South Africa for evaluating a trust's investment portfolio

There is no case law in South Africa indicating that trustees should follow the total portfolio approach. As a matter of fact, the following paragraph in *Estate Richards* signals quite the opposite:[86]

> "Nonetheless, it must not be overlooked that every investment in shares (and unit trusts) carries with it the inherent risk of capital loss. A trustee exercising due diligence and care will bear this in mind when purchasing shares both in regard to their selection and the balance of his share portfolio. He will accordingly avoid investments which are of a speculative nature. The extent to which it will be prudent to invest in the share market must necessarily depend on the circumstances of each case. Generally speaking, however, a trustee will as far as is practicable seek to spread the investments of the trust over various forms of undertaking in order to obtain a balance of stability and growth in the capital value of the trust and the income it produces."

Essentially what Scott JA is indicating here is that when constructing an investment portfolio, trustees should choose a mixture of higher risk investments (which could bring greater returns) and more secure investments (which would produce lower returns but expose the trust fund to less risk).[87] An investment rule based on MPT, on the other hand, requires more than simply investing in different assets with different levels of risk.[88] Investments must be selected based on their contribution to the overall portfolio rather than their individual risk attributes.[89] The

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[85] Ruce (2012) *South Texas LR* 662-663.

[86] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 558H-I.

[87] For a discussion of this particular style of portfolio construction, see SR Chowdhury "Whether or not the law relating to modern trustees' power and duties have achieved a balance between managing the trust assets and protecting the interest of the beneficiaries: a critical analysis" (2015) 6 *Mediterr J Soc Sci* 386 388 and R Thornton "Ethical investments: a case of disjointed thinking" (2008) 67 *Cambridge LJ* 396 400.

[88] S Midness "Minnesota's prudent investor rule: aligning law" (1997) 23 *Wm Mitchell LR* 713 732-733.

[89] Aalberts & Poon (2006) *Ohio St LJ* 535.

goal for trustees is to find assets that complement one another.[90] Trustees investing in accordance with MPT would thus combine assets that have a low correlation with each other.[91]

An even stronger indication that Scott JA is not advocating that trustees should follow the total portfolio approach, is the fact that he states that trustees should avoid investments of a speculative nature. A requirement to avoid speculative investments is incompatible with the total portfolio approach, since in terms of this approach the riskiness of investments is considered only in light of the overall portfolio. This means that in terms of the total portfolio approach, an investment cannot be characterised as "safe" or "speculative" in abstract isolation.[92] Instead, before rejecting a risky asset as speculative *per se*, trustees should consider the possible role of that asset in the portfolio.[93]

In conclusion, it is safe to state that the isolation approach is currently used in South African trust law to evaluate a trust's investment portfolio.

3 4 The current position in each of the relevant jurisdictions

The Prudent Investor Act, effective as to investments made or held by trustees on or after 1 January 1995, codifies a prudent investor rule for New York, thereby replacing New York's prudent man rule.[94] In chapter 4, this rule is referred to as New York's prudent investor rule. The rule requires trustees to:[95]

> "… pursue an overall investment strategy to enable the trustee to make appropriate present and future distributions to or for the benefit of the beneficiaries under the governing instrument, in accordance with risk and return objectives reasonably suited to the entire portfolio …"

The rule also requires trustees to consider, among other things:[96]

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[90] Midness (1997) *Wm Mitchell LR* 732-733.

[91] For a discussion of portfolio construction and correlation, see chapter 3 para 3 1.

[92] MM Schanzenbach & RH Sitkoff "The prudent investor rule and trust asset allocation: an empirical analysis" (2009) 35 *ACTEC J* 314 318-319.

[93] EA Moses, JC Singleton & SA Marshall "Modern portfolio theory and the Prudent Investor Act" (2004) 30 *ACTEC LJ* 165 172.

[94] S 11-2.3(a) of the Prudent Investor Act.

[95] S 11-2.3(b)(3)(A).

[96] S 11-2.3(b)(3)(B).

"… the role that each investment or course of action plays within the overall portfolio …"

New York's prudent investor rule, therefore, clearly indicates the acceptance of the total portfolio approach.

Chapter 5 illustrates that the total portfolio approach should be regarded as part of English trust law, at least as from 1996. In the *Nestle* case, Hoffmann J stated:[97]

"Modern trustees acting within their investment powers are entitled to be judged by the standards of current portfolio theory, which emphasises the risk level of the entire portfolio rather than the risk attaching to each investment taken in isolation."

The English Trustee Act 2000 does not mention MPT or the total portfolio approach directly. However, according to the Explanatory Notes that accompany the Act, the Act does take account of MPT indirectly. The Explanatory Notes state that the definition of the "standard investment criteria" accords with MPT:[98]

"The definition of the standard investment criteria in section 4(3) is closely modelled on section 6(1) of the Trustee Investments Act 1961 and accords with modern portfolio theory."

Existing law in New Zealand hints at the acceptance of the total portfolio approach. Section 13E of the Trustee Act 1956 (as amended) lists the matters that trustees should have regard to when investing. One of the matters that trustees should consider is "the nature of existing trust investments and other trust property".[99] However, Butler argues that section 13E does not go far enough in making the compatibility of the total portfolio approach and investment management obvious. He suggests that in order to make the acceptability of the total portfolio approach more apparent, section 13E should rather state that, when making an investment, trustees must have regard to "the relationship of that investment to other investments in the investment package".[100] According to Butler, an express statement to this effect would satisfy any concerned trustee following a MPT style of

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[97] Moffat *Trust Law* 483, referring to *Nestle v National Westminster Bank Plc* (1996) 10 (4) T.L.I. 112 113.

[98] Note 25 of the Explanatory Notes accompanying the Trustee Act 2000.

[99] S 13E(b) of the Trustee Act 1956 (as amended).

[100] Butler (1995) *Bond LR* 148.

trustee investing that the total portfolio approach has statutory approval and that the trustee's approach would be readily defensible before a court. Butler believes that current legislation fails to do this explicitly.[101]

The New Zealand Law Commission also indicated that they are not satisfied with the law as it is currently operating and recommended two changes to the Trustee Act 1956 (as amended): first, section 13E of the Act should be redrafted to provide that trustees may take their overall investment strategy into account when exercising their powers of investment; and, second, new legislation should clarify that the rule of general trust law, which requires that the decisions of trustees are assessed on an investment-by-investment basis if their investment decisions are called into question, should be abolished.[102] It appears that the aim of the second recommendation is to place beyond all doubt that once the new legislation has been enacted, the isolation approach will effectively be abolished and trustees will have to follow the total portfolio approach.

The Trusts Act 2019 indicates the acceptance of the total portfolio approach in the following two ways: first, section 59(1)(n) of the Act requires trustees to consider their "overall investment strategy" when exercising their power of investment.[103] Second, in terms of section 128 of the Act, in an action for breach of trust, the court may take into consideration whether an investment was made in accordance with an investment strategy.[104] Section 128 is a redraft of section 13M of the Trustee Act 1956 (as amended). Section 59(1)(n) of the Trusts Act 2019 read in conjunction with section 128 of the Act support the conclusion that the total portfolio approach is a legitimate trustee investment strategy under the Trusts Act 2019.

3 5 Determining the prudence of a trust's overall investment strategy

In place of a duty to avoid speculative investments, an investment rule based on MPT requires trustees to determine the risk/return trade-off that best suits the particular trust and then to tailor that trust's overall investment strategy

[101] 148-149.

[102] New Zealand Law Commission *Review of the Law of Trusts – A Trusts Act for New Zealand* (2013) Report 130 131.

[103] S 59(1)(n) of the Trusts Act 2019.

[104] S 128.

accordingly.[105] A trust's overall investment strategy will thus be viewed as prudent if the trustees invest at a level of risk-and-return that is suitable for that particular trust.[106] In order to determine what would be regarded as a suitable level of risk-and-return, trustees must take the circumstances of each particular case into account.[107]

By comparing New York's Prudent Investor Act and New Zealand's Trusts Act 2019, as well as taking the discussion regarding general and specific circumstances in chapter 2 into consideration, it is suggested that trustees should consider the following circumstances in investing and managing trust assets:[108]

(a) the purpose and terms of the trust;
(b) the size of the trust estate;
(c) the estimated duration of the trust;
(d) general economic conditions;[109]
(e) the possible effect of inflation or deflation;
(f) the need to maintain the real value of the capital of the trust and to ensure the production of adequate income;
(g) the expected tax consequences of investment decisions or strategies;
(h) the role that each investment or course of action plays within the overall trust portfolio;[110]
(i) the expected total return of the portfolio (including both income and appreciation of capital);[111]
(j) the needs of the beneficiaries (to the extent reasonably known to the trustees) for present and future distributions;
(k) other resources of the beneficiaries; and
(l) other relevant matters worth considering.[112]

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105 Langbein (1996) *Iowa LR* 650; Schanzenbach & Sitkoff (2009) *ACTEC LJ* 319.

106 Radigan (05-09-2010) *Ruskin Moscou Faltischek* <http://www.rmfpc.com/advisory-committee-prudent-investor-act/> (accessed 04-11-2016) 3; Horn (1998) *Real Prop Prob & Tr J* 57.

107 Duckworth (1997) *PCB* 30; Schwartzel (2002) *Baylor LR* 716.

108 See s 11-2.3(b)(3)(B) of the Prudent Investor Act; s 59 of the Trusts Act 2019; and chapter 2 para 4 2.

109 See chapter 2 para 4 2.

110 See s 11-2.3(b)(3)(B) of the Prudent Investor Act and s 59(1)(n) of the Trusts Act 2019.

111 For a discussion of total return investing, see para 5 3 below.

A possible concern with the adoption of the total portfolio approach might be that it would lead to future trust portfolios only being filled with exceptionally risky assets.[113] However, any concerned beneficiary should find comfort in the fact that before investing in a particular investment, trustees following the portfolio approach must demonstrate that the investment advances the overall investment strategy. New investments are viewed as advancing the overall investment strategy if these investments are employed in a manner that reduces the overall risk of the investment portfolio, or allow the portfolio to achieve a higher return expectation without a disproportionate increase in the overall level of portfolio risk.[114]

It follows from the foregoing that even in terms of the total portfolio approach it is possible that a particular investment might be regarded as imprudent. Gordon illustrates this point by applying the total portfolio approach to the cases that underpin Scott's rule against investing in speculative investments. What is remarkable is that Gordon found that in applying the total portfolio approach to these cases, not one of them would come out differently.[115] For example, in *St. Germaine v Tuttle*,[116] the trustee invested more than one-third of an $8 000 fund in a heavily indebted company owned by his family. On the court's theory, the investment was speculative. According to Gordon, under the total portfolio approach the investment of so large a percentage of a portfolio in such an investment would also be regarded as imprudent because it would make the portfolio as a whole too risky.[117] Gordon points out that such an investment would be imprudent because of the risk it adds to the portfolio and not the risk of the investment *per se*.[118]

3 6 Conclusion and proposed changes to legislation

South African trust law requires trustees' investment decisions to be assessed on an investment-by-investment basis if these decisions are called into question. This approach is referred to as the isolation approach. The problem with the isolation

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[112] For example, see the factors that were considered in *In re Hyde*, 2007 WL 3101810 (N.Y.A.D. 3 Dep't. 2007) discussed in para 4 6 3 1 below.

[113] Langbein (1996) *Iowa LR* 650.

[114] See para 2 4 above.

[115] Gordon (1987) *N Y U LR* 67.

[116] 44 A.2d 137 (1945).

[117] Gordon (1987) *N Y U LR* 67-68.

[118] 70.

approach is that, first, it tends to label broad categories of investments and techniques as speculative and thus as imprudent *per se* and, second, it exposes trustees to liability for a decline in the value of one investment even if that investment is part of a well-diversified portfolio.

Jurisdictions such as New York and England have moved from the isolation approach to an approach that evaluates trustees' performance in light of the performance of the entire portfolio (referred to as the total portfolio approach), while New Zealand is in the process of also making this shift. Currently, existing law in New Zealand does not go far enough in making the compatibility of the total portfolio approach and trustee investing obvious. The New Zealand Law Commission recommended that reforming legislation ought to require trustees to look at a trust's investment portfolio as an interlocking whole and not just at its individual elements. Accordingly, the Trusts Act 2019 includes provisions that indicate the acceptance of the total portfolio approach.

Before proceeding to consider how South Africa should adopt the total portfolio approach, a brief review of the discussion in the preceding section is in order. It is proposed above that the current rule governing trustees' investment functions should be replaced with a prudent investor rule by inserting a new section, section 9A, into the Trust Property Control Act. Subsection (1) of section 9A codifies and clarifies trustees' standard of care when investing, and subsection (2) gives trustees wide powers of investment.

With regard to adopting the total portfolio approach, two further changes to the Trust Property Control Act are proposed: first, subsection (3) should be added to section 9A, requiring trustees to:

> "… pursue an overall investment strategy in accordance with the level of risk-and-return reasonably suited to the entire trust portfolio …"

Second, in order to determine what would be regarded as a suitable level of risk-and-return, trustees must take the circumstances of each particular case into account. Accordingly, subsection (4) of section 9A should list the specific and general circumstances that trustees should consider before making investment decisions. The contents of the list are listed above,[119] but it is worth highlighting the provision that relates specifically to the total portfolio approach:

> "[Trustees should consider] the role that each investment or course of action plays within the overall trust portfolio."

It is submitted that these two proposals would give concerned trustees the necessary confidence that the total portfolio approach has statutory approval and that the approach would be readily defensible before a court.

4 The diversification of trust investments

4 1 Introduction

The purpose of this section is to discuss the third area of trustee investment affected by the implementation of MPT, namely, the diversification of trust investments. The section starts by describing diversification from a MPT perspective. This first part also explains why an investment rule based on MPT generally compels trustees to use diversification. Next, the differences between the approach to diversification of the prudent man rule and the approach of the prudent investor rule are discussed. Following this discussion, the approaches to diversification in each of the comparable foreign jurisdictions are reviewed briefly. This is followed by a discussion of the position in South African trust law with regard to diversification. The second-last part of the section is devoted to answering the question: when will it be in the interest of beneficiaries not to diversify? The section concludes with a summary, which is accompanied by proposals of how legislation should change in order to make it possible for trustees to diversify in accordance with MPT.

4 2 Diversification defined

Most investment professionals use the term "diversification" to denote the spreading of one's wealth over a variety of investments. MPT instructs that diversification entails more than simply investing in different investments.[120] Instead, MPT illustrates that diversification should be implemented with "an eye to finding

[119] See para 3 5 above.

[120] S Midness "Minnesota's prudent investor rule: aligning law" (1997) 23 *Wm Mitchell LR* 713 732-733.

assets that complement each other and eliminate uncompensated risk".[121] This statement requires clarification.

Uncompensated risk, or unsystematic risk as it is called in this dissertation, refers to the risk that surrounds an individual security and is peculiar to that security. The other component of risk, namely, systematic risk, is the risk common to all securities and reflects general economic, political and social conditions.[122] Systematic risk cannot be diversified away within a market.[123] Unsystematic risk, by contrast, can be reduced greatly through diversification.[124]

Investments complement each other when they do not go up and down in value at the same time. In technical terms, investors should combine investments that have a low co-variance with each other.[125] Diversification, therefore, requires investors not to invest in a number of companies that all deal in the same market, for example, motor vehicle manufacturing, because if there is a fall in the market, the entire value of the portfolio will fall.[126] According to Lofthouse, investing in similar companies, all of which are subject to the same external influences, is almost tantamount to putting all your money into one investment.[127]

By finding investments that complement each other, investors can theoretically reduce all unsystematic risk since the setbacks experienced by one company are offset by the gains of another.[128] The only risk remaining in the portfolio will be systematic risk.[129] In contrast, there will be systematic *and* unsystematic risk in a

[121] 733.

[122] Schwartzel (2002) *Baylor LR* 720.

[123] Thornton (2008) *Cambridge LJ* 400. Systematic risk can, however, be mitigated through using the right asset allocation strategy: Schwartzel (2002) *Baylor LR* 733. For a discussion on how risk can be adjusted downwards, see chapter 3 para 5 2.

[124] Langbein (1996) *Iowa LR* 648.

[125] HM Markowitz "The early history of portfolio theory" (1999) 55 *FAJ* 5 8; NC Klein "Augmenting liability risks for trustees in the light of modern financial theory – the potential of the prudent investor rule and its portfolio diversification requirement" (2014) 20 *T & T* 692 694.

[126] A Hudson *Equity and Trusts* 8 ed (2015) 440.

[127] S Lofthouse "Nestle v National Westminster Bank Plc: flawed reasoning?" (1997) *PCB* 232 235.

[128] Bines (1976) *Columbia LR* 752; Schwartzel (2002) *Baylor LR* 720.

[129] Begleiter (1999) *Maine LR* 34.

non-diversified portfolio.[130] Therefore, the risk of a non-diversified portfolio will always be higher than a diversified portfolio.[131]

It is important to stress that diversification permits the risk of an investment portfolio to be reduced without lowering the portfolio's return expectations:[132]

> "By holding a diversified portfolio of investments, trustees reduce the overall level of risk run by their beneficiaries without, however, reducing the total of their returns from the individual investments."

The fact that diversification enables trustees to reduce risk substantially while keeping expected returns constant makes diversification fundamental to risk management.[133] Consequently, an investment rule based on MPT generally compels trustees, absent special circumstances, to use diversification to find investments that complement each other and eliminate unsystematic risk.

4 3 The prudent man rule versus the prudent investor rule

The prudent investor rule of the Restatement (Third) (in this section referred to as the "prudent investor rule") is a good example of an investment rule based on MPT.[134] The Restatement (Third) imposes on trustees an affirmative obligation to diversify trust investments.[135] Similar to the rest of trust investment law, the duty to diversify is a default rule. Therefore, the prudent investor rule permits trustees not to diversify, but only under special circumstances. These circumstances are discussed below.[136]

The prudent man rule of the Restatement (Second) (in this section referred to as the "prudent man rule") did not necessarily frown on diversification as a concept of trust fund management. As a matter of fact, the prudent man rule required investments to be diversified.[137] However, there are three key differences between the prudent man rule and the prudent investor rule when it comes to diversification:

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[130] Bines (1976) *Columbia LR* 758.

[131] 753.

[132] Mowbray et al *Lewin on Trusts* 1286.

[133] Halbach (1992) *Real Prop Prob & Tr J* 433.

[134] See para 3 2 above.

[135] Sterk (2010) *Cornell LR* 863.

[136] See para 4 6 below.

[137] Haskell (1990) *North Carolina LR* 91.

first, the prudent man rule required diversification, but only among non-speculative investments,[138] whereas trustees investing in accordance with the prudent investor rule are free to diversify using any investment.[139] Second, the prudent man rule required trustees to evaluate prudence one investment at a time, whereas the prudent investor rule allows trustees to evaluate the performance of a portfolio as a whole.[140] Third, under the prudent investor rule, the purpose of diversification has been broadened significantly.[141] These differences require further discussion.

Since the prudent investor rule is based on MPT, it requires a certain type of diversification.[142] More specifically, the rule does not simply require trustees to choose different types of investment; instead, it requires trustees to choose investments that have offsetting risks.[143] However, choosing investments that have offsetting risks will often lead to trustees having to select investments that are seen as speculative or risky viewed in isolation. As explained in chapter 3:[144]

> "MPT's focused attention on the portfolio as a whole means that injecting an asset that is highly volatile in itself into a portfolio is not necessarily illogical. Intuitively, it is not obvious that adding high-risk stocks (eg small capitalisation stocks) to a portfolio of low-risk investments (eg government bonds) would make the portfolio less risky than a portfolio composed entirely of low-risk investments. But, as seen above, it is possible to reduce a portfolio's risk by adding an asset that moves inversely to the other investments of the portfolio."

In Levy's example, discussed in chapter 3, an investor has to add small capitalisation stocks to his portfolio in order to reduce the risk of the portfolio of government bonds. The small capitalisation stocks are twice as volatile as the bonds, but since the correlation between the two investments is low, the addition of the stocks reduces the risk of the portfolio.[145]

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138 94; Levy (1994) *George Mason U LR* 8.

139 Schwartzel (2002) *Baylor LR* 716.

140 Sterk (2010) *Cornell LR* 861 and 864.

141 Schwartzel (2002) *Baylor LR* 722.

142 See chapter 5 para 4 5 1.

143 Penner *The Law of Trusts* 275-276.

144 See chapter 3 para 4.

145 See chapter 3 para 3 1 3.

The inclusion of higher risk investments in a portfolio is thus simply unavoidable for trustees investing in terms of an investment rule based on MPT. The drafters of Restatement (Third) understood and accepted this.[146] Accordingly, the drafters eliminated the prohibition on speculative investments and made it possible for trustees to be evaluated on the performance of the portfolio as a whole.[147] The consequence of these changes is that trustees following the prudent investor rule are better equipped to select investments with offsetting risks, because they can make any kind of investment and select investments based on their contribution to the overall portfolio rather than their individual risk attributes.

According to Schwartzel, the purpose of diversification has been broadened significantly under the prudent investor rule. As discussed above, trustees who fail to diversify introduce unsystematic risk to a portfolio.[148] Furthermore, trustees who fail to diversify are not compensated with additional returns.[149] In terms of the prudent investor rule, the purpose of diversification is not only to moderate risks that are inherent in investing, but also "to reduce risks that are not justified by some prospect of gain". Stated differently, the purpose of diversification is not only to prevent large losses, but also to reduce as far as possible the risk of a portfolio that is not compensated for by the market by way of greater return. What has changed, therefore, is that the goal of trustees is now also to prevent the trust portfolio from carrying excessive unsystematic risk.[150]

4 4 The current position in each of the comparable foreign jurisdictions

New York's prudent investor rule requires a trustee to:[151]

> "… diversify assets unless the trustee reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes and terms and provisions of the governing instrument; and … within a reasonable time after the creation of the fiduciary relationship, to determine whether to retain or dispose of initial assets."

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[146] Ruce (2012) *South Texas LR* 671 and 690.

[147] Sterk (2010) *Cornell LR* 864.

[148] See para 4 2 above.

[149] Langbein (1996) *Iowa LR* 648; Bines (1976) *Columbia LR* 758.

[150] Schwartzel (2002) *Baylor LR* 722; Begleiter (1999) *Maine LR* 27 61.

[151] Ss 11-2.3(b)(3)(C) and (D) of the Prudent Investor Act.

Before the enactment of the Prudent Investor Act in 1995, it was a well-established rule in New York that there was no absolute duty to diversify, and a failure to do so was not necessarily imprudent.[152] Diversification was not obligatory as a matter of law; instead it was only a fact that could be considered to determine whether trustees had exhibited the requisite degree of skill and care in structuring a portfolio.[153] Radigan and Farinacci summarise the position since the enactment of the Prudent Investor Act as follows:[154]

> "… trustees have a presumed duty to diversify investments and may be liable if they neglect to do so …"

In England, trustees are required to pay heed to "the need for diversification of investments of the trust, in so far as is appropriate to the circumstances of the trust".[155] Strictly speaking, trustees are not obliged to diversify but they are duty-bound to consider diversification. Nevertheless, if the trust fund is substantial and the power of investment is unrestricted, the trustees would need good reason not to diversify. As Le Poidevin states it:[156]

> "... a trustee would need to have some good reason for putting all its eggs in one basket."

Trustees in England have long recognised the importance of diversification through the holding of a varied portfolio of investments.[157] For instance, the Trustee Investments Act 1961 required trustees to have regard to the need for diversification of investments so far as appropriate to the circumstances of the trust.[158] The Trustee Act 2000 in effect re-enacts the section in the Trustee Investments Act 1961 that deals with diversification.[159] But this is not to say that the Trustee Act 2000 did not bring about any changes. A major improvement of the Act is that it better equips

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[152] Gordon (1987) *N Y U LR* 98.

[153] Haskell (1990) *North Carolina LR* 91-92.

[154] CR Radigan & JG Farinacci "'Knox,' the prudent investor and fiduciary duties" (2012) *N Y LJ* 1 1 available at: <http://rmfpc.com/wp-content/uploads/2013/03/Knox-the-Prudent-Investor-and-Fiduciary-Duties_JF1.pdf> (accessed 30-04-2019).

[155] S 4(3)(b) of the Trustee Act 2000.

[156] N le Poidevin "The worried trustee" (2009) 15 *T & T* 596 600.

[157] Thornton (2008) *Cambridge LJ* 400.

[158] The Law Commission and the Scottish Law Commission *Trustees' Powers and Duties* 14.

[159] PJ Reed & RC Wilson *The Trustee Act 2000 – A Practical Guide* (2001) 44.

trustees to choose investments with offsetting risks since trustees can now make any kind of investment. Furthermore, as a consequence of the *Nestle* case, trustees are entitled to be judged by the total portfolio approach as opposed to the isolation approach.[160] The end result is that trustees have been able to diversify more effectively since 2000.

In New Zealand, section 13E of the Trustee Act 1956 (as amended) sets out a list of factors that trustees may have regard to in exercising powers of investments.[161] The desirability of diversification is expressly recognised in the list.[162] While arguably there is no duty to diversify under the Act,[163] trustees who do not diversify act at their own peril. For example, if it is believed that the trustees of a particular trust have failed to meet the standard of prudence expected of them, the beneficiaries may hold the trustees accountable for a loss to the trust fund. In such a case, the court will consider all relevant circumstances, including any of the factors listed in section 13E. Moreover, section 13M of the Act directs the attention of the court specifically to the issue of diversification.[164] The section allows the court to have regard to two matters in determining whether trustees have acted prudently: first, the court may have regard to whether the trust investments have been diversified; and second, it is open to the court to consider whether the investment has been made pursuant to an investment strategy. Since diversification is mentioned in both section 13E and section 13M, one cannot help to feel that the drafters of the Act saw diversification as paramount to the interest of beneficiaries.

Section 13E and section 13M are restated in the Trust Act 2019 as section 59 and section 128, respectively.

4 5 The position in South African trust law

There are three significant points to note about diversification in South African trust law: first, Scott JA in *Estate Richards* encourages the "spreading of

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[160] See chapter 5 para 5 2.

[161] See also s 59 of the Trusts Act 2019.

[162] S 13E(a) of the Trustee Act 1956 (as amended). See also s 59(1)(b) of the Trusts Act 2019.

[163] Manns (1998) *Victoria U Wellington LR* 628.

[164] Kelly et al *Law of Trusts* 598. See also s 128 of the Trusts Act 2019.

investments" and not the "diversification of investments". Scott JA stated the following:[165]

> "Generally speaking, however, a trustee will as far as is practicable seek to spread the investments of the trust over various forms of undertaking in order to obtain a balance of stability and growth in the capital value of the trust and the income it produces."

As discussed in paragraph 3 3 above, what Scott JA indicated by this statement is that when constructing an investment portfolio, trustees should choose a mixture of higher risk investments (which could bring greater returns) and more secure investments (which would produce lower returns but expose the trust fund to less risk). As already pointed out in this chapter, diversification requires more than simply investing in different types of investment.[166] Diversification requires trustees to choose investments that have offsetting risks.

Second, there is no *duty* to spread investments. Where then does the need to spread investments over various forms of undertaking fit into trust law? The answer appears to be this: De Waal states that trustees should test their investment strategy against five practical guidelines formulated in *Estate Richards*. One of these practical guidelines is whether the trustees have spread the trust's investments over various market sectors.[167]

Third, when compared with the prudent man rule and the prudent investor rule, it appears that the South African approach to the spreading of investments corresponds with the prudent man rule. This statement is based on the following factors: trustees in South Africa should avoid speculative investments;[168] trustees are judged according to the isolation approach;[169] and Scott JA did not give any indication that trustees should strive to eliminate unsystematic risk.

4 6 Restricting diversification

An important question that surrounds the duty to diversify is: when is it in the interest of beneficiaries not to diversify? Bearing the importance of diversification in

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[165] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 558I-J.

[166] See para 4 3 above.

[167] MJ de Waal "Die strekwydte van trustees se beleggingsbevoegdheid" (1999) 2 *TSAR* 370 377.

[168] See para 2 2 above.

[169] See para 3 3 above.

mind, it is suggested that a failure to diversify should only be justified in very unusual situations. The three most common situations found in the relevant jurisdictions are circumstances in which: the value of the trust fund is relatively small; [170] diversification will lead to a considerable tax cost; [171] and the trust instrument contains a retention clause. Each of these situations are examined below in order to determine whether they can legitimately restrict diversification, and how trustees following an investing rule based on MPT should deal with such restrictions.

4 6 1 The size of a fund

The first situation in which restricting diversification may be appropriate is if the trust fund is relatively small. Hudson explains the thinking behind this possible exception to diversification as follows:[172]

> "… if the trust fund were comprised of only £10 000 in free cash, then it would be unreasonable to expect that a trustee would be able to diversify the trust's investment portfolio as broadly as a trust containing £10 million because clearly the larger trust can afford many more different types of investment and can better afford the fees involved with buying that number of investments."

He concludes that the need to diversify is reduced significantly in the case of a £10 000 fund:[173]

> "Thus a trust comprising £10 million may include hundreds of different investments in its portfolio, whereas a trust fund including only £10 000 may have only six or seven different, carefully-selected investments in different markets."

However, it is submitted that the smallness of a trust fund should not be used as an excuse to restrict diversification. Instead of investing in six or seven investments, as suggested by Hudson, trustees could invest in an index fund tracking a market index. As discussed in chapter 3, an *index fund* is designed to match or track the components of an established index of stocks or some other investment type, while a

[170] Haskell (1990) *North Carolina LR* 91; AJ Oakley *Parker & Mellows: The Modern Law of Trusts* 8 ed (2003) 604.

[171] Schwartzel (2002) *Baylor LR* 730.

[172] Hudson *Equity and Trusts* 441.

[173] 441.

market index is intended to represent an entire stock market. An index fund that is constructed to approximate the performance of a market index is referred to in chapter 3 as a market index fund.[174] Therefore, even with an initial investment amount of only £10 000, trustees are able to invest in a highly diversified portfolio by investing in a market index fund.

4 6 2 Tax considerations

The second situation in which restricting diversification may be appropriate is if the tax costs of recognising a gain may outweigh the advantages of diversifying the fund. Consider the following example: a trust owns a large number of shares in a company listed on the JSE. A substantial capital gains tax may be triggered if the shares are sold to diversify the portfolio. The trustees face a difficult problem: if they sell the shares it might result in a large taxable gain; if they opt to retain the shares, they run the risk of personal liability. The shares can either perform as well as anticipated or fail to perform and gradually decline in value. In the latter event, the trustees will be held accountable for the losses.

According to Collins and Stampfli, it is more advantageous to sell the shares, pay the tax costs, and invest the proceeds in a diversified portfolio.[175] This suggestion is based on a comparison that Collins and Stampfli made on what the results would be if the trustees of a portfolio, consisting of shares in a company listed on the S&P 500 with a value of $1 million and a base cost of $0, stayed invested in the company versus if the trustees sold the shares and invested the after-tax proceeds in an S&P stock index.[176] After running a thousand trial simulations of portfolio values, they found that the "most likely" outcome is that the portfolio values would virtually be equal at year ten. Thereafter, the diversified portfolio dominates the single-stock portfolio by evidencing higher inflation-adjusted values.[177]

Trustees who wish to retain investments owing to tax reasons should also consider the bankruptcy rate of a single-stock portfolio. Collins and Stampfli found that the bankruptcy rate of a single-stock portfolio by year twenty is 41%. Thus, in

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[174] See chapter 3 para 5.

[175] P Collins & J Stampfli "Promises and pitfalls of total return trusts" (2001) 27 *ACTEC J* 205 217.

[176] 215.

[177] 216.

41% of all trials, the portfolio value reduced to zero before the end of the twenty-year period.[178]

As a side note, it is worth mentioning that there is an alternative risk-reduction strategy available to trustees following an investment rule based on MPT. The trustees could buy a put option on the shares in question. The put option's value will increase in the event that the price of the underlying shares declines. The viability of this strategy will depend on the costs of buying the put option.[179]

4 6 3 Retention provisions

The final situation in which restricting diversification may be appropriate is the following: the founder of a trust, whether the founder of a testamentary or an *inter vivos* trust, might direct that a particular asset should be retained within the trust fund. In order to determine how trustees following an investment rule based on MPT should deal with such an instruction, it is necessary to analyse the different types of retention provision. Following this analysis, this section also examines a situation in which the founder has expressed the wish that a certain asset should be retained for the occupation of beneficiaries.

According to the Restatement (Third), retention provisions come in two forms: "permissive" and "mandatory".[180]

4 6 3 1 Permissive retention provisions

Permissive retention provisions can be divided into "specific" and "general". In a specific permissive retention provision, the founder specifies a particular asset that is to be retained.[181] For example, say a testator has worked for a certain public company called "XYZ" most of his life and has accumulated a large number of shares in XYZ throughout his career. He dies and leaves the shares in XYZ in trust. The shares are the only substantial asset of the trust. In his will he provided that "it is my desire and hope that my trustees shall not dispose of my XYZ shares". In a letter

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[178] 217.

[179] Langbein (1996) *Iowa LR* 661; G Crawford "A fiduciary duty to use derivatives?" (1995) 1 *Stanford JL Bus & Fin* 307 312.

[180] DT Leibell, DL Daniels & Paulina Mejia "Holding family business interests in trust" (2012) 13 *NAEPC J Est & Tax Plan* 48 51.

[181] 51.

addressed to the trustees he explains his thinking as follows: "I worked for XYZ for 35 years, the share price of XYZ rocketed in value throughout my career. You just cannot do better".[182]

In this example, the testator is imposing his supposed investment wisdom on the trustees. According to Langbein, the testator's investment strategy is "objectively stupid and imprudent" since it will result in the trustees having to bear additional risk (in the form of unsystematic risk) without any compensating advantage.[183] In New York, because permissive retention provisions do not abrogate trustees' duty to act prudently, and because diversification is fundamental to risk management, trust provisions are strictly construed against dispensing with the diversification requirement.[184] A specific permissive retention provision will thus not be viewed by a New York court as sufficient to protect trustees from liability for failure to diversify.

Another example of a specific permissive retention provision involves the expression of a wish to retain shares in a family-owned company. Langbein suggests that trustees should be given more leeway not to diversify if a family company is involved.[185] While on the subject, one can also go a step further and argue that even in a trust with no retention provision, a family company should still receive special consideration and treatment from a diversification point of view.[186] According to Langbein, by comparison with the previous example concerning the investment of shares in a public company, authorisation to retain a family company presents more varied circumstances.[187] First, trustees may wish to retain a family company because it would continue to be a source of income, employment or direct involvement for beneficiaries.[188] Second, a family company sometimes occupies a market niche that produces returns superior to those readily available to the trustees in the ordinary

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[182] The example is based on Langbein's IBM example: see Langbein (1996) *Iowa LR* 664.

[183] 664.

[184] Leibell et al (2012) *NAEPC J Est & Tax Plan* 51-52; Radigan (05-09-2010) *Ruskin Moscou Faltischek* <http://www.rmfpc.com/advisory-committee-prudent-investor-act/> (accessed 04-11-2016) 3-4.

[185] Langbein (1996) *Iowa LR* 665. The same applies to the ownership of a family farm: D Kidd "Family farms and the prudent investor rule's requirement of diversification" (2010) 15 *Drake J Agric L* 505.

[186] See Schwartzel (2002) *Baylor LR* 727-728.

[187] JH Langbein "Burn the Rembrandt? Trust law's limits on the settlor's power to direct investments" (2010) 90 *Boston U LR* 373 394.

[188] JH Langbein "Mandatory rules in the law of trusts" (2004) 98 *Northwestern U LR* 1105 1115-1116.

investment market.[189] Third, Cooper argues that trust law is not exclusively about economics, but also includes a personal element to some extent.[190] Therefore, a founder's personal visions of wealth transmission should be a worthwhile factor for trustees to consider.[191] Fourth, the family company might have held sentimental value not just for the founder, but it may also hold sentimental value for the beneficiaries.[192] Fifth, selling the shares in a family company is more difficult than selling liquid, widely-held shares in a public company.[193]

In re Hyde[194] serves to illustrate how various factors can be considered in deciding whether to retain shares in a family company. In this New York case, a majority shareholder of a large manufacturing company established multiple testamentary trusts at her death, each funded with her shares in the family company. The company was a closely held family business, the shares of which were not publicly traded. The corporate trustees of the different testamentary trusts decided to retain the shares in the company after the death of the testatrix. The beneficiaries objected, claiming that the trustees failed to diversify the trust investments adequately. The court, finding in favour of the trustees, noted that the trustees took the following factors into account in deciding to retain the shares in the company: first, they considered the liquidity (or lack thereof) of the company and the fact that the trustees could only obtain a discounted price if they tried to sell the shares in the company. The trustees determined that it was not in the best interest of the beneficiaries to sell the shares at a low price merely for the sake of diversification. In addition, the lack of marketability of the company was exacerbated by the company's unusual capital structure. Second, the trustees also took into account general economic conditions, the adverse tax consequences of the sale of the shares, and the fact that the company paid considerable dividends. Third, there was an indication that the testatrix wanted the shares in the company to remain in the family and that the trusts were the vehicles chosen to achieve that result. It is unclear from a reading

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[189] 1115.

[190] JA Cooper "Empty promises: settlor's intent, the Uniform Trust Code, and the future of trust investment law" (2008) 88 *Boston U LR* 1165 1169-1170.

[191] 1170; Klein (2014) *T & T* 704.

[192] Kidd (2010) *Drake J Agric L* 517.

[193] Langbein (2010) *Boston U LR*392.

[194] 2007 WL 3101810 (N.Y.A.D. 3 Dep't. 2007).

of the judgment whether this indication came from a wish in the will, a letter of wishes to the trustees, or a conversation that the testatrix had with the trustees when the will was drafted. In light of all these factors, the court held that the trustees were not liable for failing to diversify.[195]

In a general permissive retention provision, the founder does not mention any specific asset or assets, but permits the trustees to retain any assets received from the founder.[196] For example, the retention language may permit the trustees to "retain any securities in the same form as when received" or retain "initially settled assets".[197] In New York, trustees' duty to diversify remains in such a case. Therefore, if the trust is funded with a non-controlling interest in a public company, as is the case in the XYZ example above, a general permissive retention provision would not be sufficient to protect trustees from liability for failure to diversify.[198]

4 6 3 2 Mandatory retention provisions

Mandatory retention provisions are typically binding on trustees in managing trust assets.[199] There is, however, an exception to the rule. The doctrine of "changed circumstances" permits trustees to apply to court to be excused from complying with a condition that has become impractical or inadvisable for reasons not foreseen by the founder.[200] For the issue at hand, this means that trustees who are directed by the trust instrument to retain a certain asset could petition the court for instructions if the value of an asset is expected to fall or is falling.[201]

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[195] CP Cline *The Law of Trustee Investments* (2009) 49. The judgment is available at: <https://caselaw.findlaw.com/ny-supreme-court/1303620.html> (accessed 24-06-2019).

[196] Leibell et al (2012) *NAEPC J Est & Tax Plan* 51.

[197] 52-53; P Panico "Trustees investment powers in international trust law" (2009) 15 *T & T* 96 100.

[198] Leibell et al (2012) *NAEPC J Est & Tax Plan* 52-53.

[199] 50; Kidd (2010) *Drake J Agric L* 517.

[200] JH Langbein & RA Posner "Market funds and trust-investment law II" (1977) 1 *Am B Found Res J* 1 34. In the Restatement (Third) this doctrine is codified as the "deviation doctrine": Langbein (2004) *Northwestern U LR* footnote 63.

[201] Leibell et al (2012) *NAEPC J Est & Tax Plan* 51; Langbein (2010) *Boston U LR* 395; Langbein & Posner (1977) *Am B Found Res J* 35.

The leading case applying the doctrine of changed circumstances is *Matter of Pulitzer*[202] ("*Pulitzer*"). Joseph Pulitzer ("Mr Pulitzer") died in 1911. In his will, he transferred his controlling interest in the "New York World" newspaper in trust for the benefit of his children.[203] His will included language prohibiting the trustees from selling the interest in the newspaper company under any circumstances.[204] After 1926, the company fell upon hard times and became increasingly unprofitable.[205] The trustees petitioned the court to waive the mandatory sale provision, arguing that in the light of changed circumstances it had become inadvisable to keep the interest in the newspaper. The company had operated at a loss for five years and the possibility existed that if not sold, it might become worthless.[206] Mr Pulitzer did not foresee the possibility that the company would become worthless. In fact, his expectation was that the newspaper "would flourish".[207] The court applied the doctrine of changed circumstances and gave judicial approval to the sale of the interest in the newspaper.[208] In reaching its decision, the court stated that Mr Pulitzer's dominant intent must have been to benefit the beneficiaries of the trust, while the continued operation of the newspaper was a subsidiary intention.[209] Langbein explains that if there is a conflict between these two intentions, the founder's dominant intent, which is to benefit the beneficiaries, should prevail.[210]

In South African trust law, if the trust instrument makes it clear that a particular asset must be preserved for the ultimate beneficiaries, this naturally precludes sale by the trustees.[211] It is submitted that a direction by the founder to retain a certain asset will not absolve the trustees from investigating whether the retention of the asset is in the best interest of the beneficiaries. Should the trustees find that the asset is deteriorating and is expected to keep on deteriorating, and that the decline

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202 249 N.Y.S. 87, 139 Misc. 575 (Surr. Ct. 1931). The judgment is available at: <https://casetext.com/case/matter-of-pulitzer-9> (accessed 25-06-2019).

203 Langbein & Posner (1977) *Am B Found Res J* 34.

204 Leibell et al (2012) *NAEPC J Est & Tax Plan* 51.

205 *Matter of Pulitzer* 249 N.Y.S. 87, 139 Misc. 575 528.

206 Leibell et al (2012) *NAEPC J Est & Tax Plan* 51.

207 *Matter of Pulitzer* 249 N.Y.S. 87, 139 Misc. 575 580.

208 Leibell et al (2012) *NAEPC J Est & Tax Plan* 51; Klein (2014) *T & T* 704.

209 Langbein (2004) *Northwestern U LR* 1118.

210 Langbein (1996) *Iowa LR* 664.

211 E Cameron, M de Waal & P Solomon *Honoré's South African Law of Trusts* 6 ed (2018) 358.

in value of the asset is due to circumstances that the founder did not contemplate or foresee, the trustees should apply to the court in terms of section 13 of the Trust Property Control Act for an order to sell the asset.[212] It is submitted that the trustees' application would succeed since the application satisfies both the subjective criterion (the founder's lack of contemplation or foresight) and the objective criterion (prejudice to the interests of the beneficiaries) of section 13.[213]

4 6 3 3 Property used for occupation by beneficiaries

One matter concerning retention provisions remains for comment. A founder might require the trustees to retain the ownership of a family residence for occupation by beneficiaries.[214] As a result, the trustees will not receive any rental income from the property. Viewed as an investment, allowing beneficiaries to live in a trust property rent-free appears quite imprudent, although it is clearly in the interest of the beneficiaries.[215]

It is proposed that such a property should be classified by the trustees as "not being held for investment".[216] Other assets that might also be viewed as not being held for investment include a set of valuable books, a collection of unique coins, or an antique motor vehicle.[217] Consequently, many trust portfolios will consist of an "investment portfolio" and a "non-investment component". South Africa's proposed prudent investor rule (section 9A of the Trust Property Control Act)[218] will govern the investment portfolio, whereas trustees' ordinary standard of care (section 9 of the Trust Property Control Act) will govern the non-investment component of a trust.

The reason for this distinction is that the non-investment component is not subjected to the requirements of the prudent investor rule. Otherwise, trustees would have to consider selling a house occupied by beneficiaries in order to invest in a diversified portfolio or at least consider finding investments with offsetting risks to the

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212 See De Waal (1999) *TSAR* 378, where De Waal states that s 13 of the Trust Property Control Act makes it possible for trustees to approach the court for an order expanding their investment functions.

213 F Du Toit, B Smith & A van der Linde *Fundamentals of South African Trust Law* (2018) 79.

214 Or a vacation property held for recreational use by beneficiaries.

215 Kelly et al *Law of Trusts* 612.

216 612; Langbein (2004) *Northwestern U LR* 1114-1115.

217 De Waal (1999) *TSAR* 371.

218 See para 2 5 above.

particular property. The importance of dividing the trust portfolio in this way will become even clearer when total return investing is discussed later in the chapter.[219]

4 7 Conclusion and proposed changes to legislation

The type of diversification that coincides with MPT is accomplished by finding investments that complement one another and by eliminating unsystematic risk. Two investments complement each other when they are likely to perform well under opposite market conditions or at different times. Adverse movements in one investment will be offset by positive results in the other. By finding investments that have offsetting risks, trustees can theoretically reduce all unsystematic risk in a portfolio. The only risk remaining in a diversified portfolio will be systematic risk. In contrast, there will be systematic *and* unsystematic risk in a non-diversified portfolio. Therefore, the risk of a diversified portfolio will typically be lower than that of a non-diversified portfolio. Importantly, diversification permits the risk of a portfolio to be reduced without lowering the portfolio's return expectations. The fact that diversification enables trustees to reduce the risk of a portfolio substantially while keeping expected returns constant makes diversification fundamental to the management of risk.

Choosing investments that have offsetting risks will often lead to trustees having to select investments that are seen as speculative or risky viewed in isolation. Indeed, the inclusion of higher risk investments is simply unavoidable when trustees are investing in terms of an investment rule based on MPT. In order for trustees to select investments with offsetting risks, they should be allowed to make any kind of investment and select investments based on their contribution to the overall portfolio. Therefore, three changes to South African trust law are proposed: first, trustees should be allowed to make any kind of investment; second, trustees should be allowed to follow the total portfolio approach; and third, the Trust Property Control Act should impose on trustees an affirmative obligation to diversify trust investments.

The first and second proposed changes have already been dealt with. Section 7 2 states that subsection (2) of section 9A will give trustees wide powers of investment; and section 7 3 states that subsection (3) of section 9A will allow trustees to pursue

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[219] See para 5 4 3 below.

the total portfolio approach and subsection (4) will list the circumstances that trustees should consider before making investment decisions.

Regarding the third proposed change, there is currently no duty to spread (or diversify) investments in South African trust law. The spreading of investments is rather seen as one of a number of practical guidelines against which trustees should test their investment strategy.

In response to the lessons of MPT, the need to diversify trust investments has been intensified in the comparable foreign jurisdictions: in New York, trustees have a presumed duty to diversify investments; in England, a lack of diversification should be satisfactorily explained by the trustees; and in New Zealand, diversification is regarded as paramount to the interest of beneficiaries. The New York position is the preferred approach since it most clearly spells out that trustees have a duty to diversify.

Accordingly, it is proposed that a new subsection, subsection (5), be added to section 9A of the Trust Property Control Act. The first part of the subsection will require trustees to diversify trust investments unless it is not in the interests of the beneficiaries; and the second part will require trustees to determine whether to sell or retain assets received from the founder. The reason for the inclusion of the second part requires explaining.

In South African trust law, beneficiaries, at least in the case of testamentary trusts, are entitled to trust assets in the same state in which the assets were received.[220] Taking the benefits of diversification into consideration, it is submitted that it is generally more important for trustees to diversify trust investments than to leave investments to the ultimate beneficiaries in the form given by the founder. The only circumstances under which it might be in the interest of beneficiaries to leave certain types of initial assets undisturbed is if the assets of the trust consist of a family company or if there is an asset that is not being held for investment (for example, a property used for occupation by beneficiaries). The reason for the second part of subsection (5) is thus to signal the change in law.

Consequently, it is proposed that subsection (5) of section 9A should read as follows:[221]

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[220] Cameron et al *Honoré's Law of Trusts* 349.

[221] See ss 11-2.3(b)(3)(C) and (D) of the Prudent Investor Act.

> "The prudent investor rule requires a trustee to diversify assets unless the trustee reasonably determines that it is in the interest of the beneficiaries not to diversify; and to determine within a reasonable time after the creation of the trustee relationship whether to retain or dispose of initial assets."

An important question that surrounds the duty to diversify is: when is it in the interest of the beneficiaries not to diversify? Seeing that diversification is paramount to the interest of beneficiaries, it is suggested that a failure to diversify should only be justified in very unusual situations. The section examined the following three situations: the value of the trust fund is relatively small; diversification will lead to a considerable tax cost; and the trust instrument contains a retention clause.

The conclusion reached regarding each of the situations is as follows: first, the smallness of a trust fund should not be used as an excuse to restrict diversification. Instead of investing in a small number of investments, trustees could invest in a market index fund. Second, it is safer and more advantageous to sell assets and invest in a diversified portfolio than it is to retain a concentrated position for tax reasons. Third, retention provisions can be divided into permissive and mandatory retention provisions. Permissive retention provisions relating to shares in public companies would not be sufficient to protect trustees from a failure to diversify when MPT-based diversification has been implemented. On the other hand, trustees should be given more leeway not to diversify in circumstances in which a permissive retention provisions relates to a family company. Mandatory retention provisions are binding on trustees. However, there is an exception to the rule. Should trustees find that an asset is deteriorating and is expected to keep on deteriorating, and that the decline in value of the asset is owing to circumstances that the founder did not contemplate or foresee, the trustees should apply to the court in terms of section 13 of the Trust Property Control Act for an order to sell the asset.

Finally, it is proposed that trustees should classify a property used for occupation by beneficiaries as "not being held for investment". Consequently, many trust portfolios will consist of an investment portfolio as well as a non-investment component. South Africa's prudent investor rule will govern the investment portfolio, whereas trustees' ordinary standard of care will govern the non-investment component of a trust. This notion of classifying certain properties as not being held for investment will be introduced into existing legislation by adding the following definition into section 1 of the Trust Property Control Act:

> "Trust investment portfolio means the investment component of the trust and excludes assets in the trust that are not being held for investment."

It is submitted that the proposed changes discussed in this section will enable trustees in South Africa to diversify investment portfolios in accordance with MPT.

5 Total return investing

5 1 Introduction

The purpose of this section is to discuss the fourth area of trustee investment affected by the implementation of MPT, namely the rules governing how income and capital returns are allocated to income and capital beneficiaries. The section begins by describing the problem with the current position in South African trust law. The section identifies total return investing as the solution to the problem and proceeds to explain the meaning of the concept and the benefits it provides. Next, the section discusses the different methods of facilitating total return investing. Following this discussion, the section briefly reviews the different approaches to total return investing in each of the comparable foreign jurisdictions. The second-last part of the section investigates which method of facilitating total return investing is best suited for which type of trust scenario. The section concludes with a summary, which is accompanied by proposals of how legislation should change to make it possible for trustees to operate total return investing.

5 2 The problem with the current position in South African trust law

As discussed in chapter 2, trustees in South Africa are obliged to protect the real value of trust capital and ensure that adequate income is produced continuously.[222] What is expected from trustees in this instance corresponds with the goals embodied in an investment rule based on MPT.[223] The problem is that two rules in South African trust law, namely the "traditional distribution rule" and the "duty of

[222] See chapter 2 para 4 2.

[223] Schwartzel (2002) *Baylor LR* 718.

impartiality", when read together, make it extremely difficult for trustees to achieve this goal. These two rules are discussed below as well as the reason why taking them together creates a problem for trustees.

5 2 1 The traditional distribution rule

A person in a fiduciary position, such as a trustee, is at common law under a duty to invest trust assets.[224] The object of investment is to produce gain, which, although it can arise in many forms, may be viewed as falling into two categories: first, gain may constitute income or revenue return, such as rentals on residential or commercial buildings, interest on bonds, or cash dividends on shares; and second, gain may take the form of capital appreciation.[225]

No principle in South African trust law seems more settled than the rule that income beneficiaries are entitled to income and capital beneficiaries are entitled to capital. This principle is referred to as the "traditional distribution rule" in chapter 4.[226] The traditional distribution rule states that returns from fixed-income investments and dividends from shares must be allocated to the income beneficiaries' account, while returns from the conversion of stocks must be allocated to the capital beneficiaries' account. Therefore, in terms of the rule, trustees cannot distribute part of the profit from the sale of appreciated stock to income beneficiaries.

What might not be immediately obvious when considering the traditional distribution rule, is that the rule links investment to distribution. What is meant by this statement is that one of the consequences of following the traditional distribution rule is that investment decisions taken by trustees largely determine the income level of income beneficiaries.[227] Langbein explains the link between investment and distribution as follows:[228]

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[224] See chapter 2 para 2 3. The duty does not apply to trust assets unsuited or not intended for investment.

[225] SA Medlin "Limitations on the trustee's power to adjust" (2008) 42 *Real Prop Prob & Tr J* 717 719; C Mitchell *Hayton and Mitchell: Commentary and Cases on the Law of Trusts and Equitable Remedies* 13 ed (2010) 387; Ontario Law Reform Commission *Report on the Law of Trusts* (1984) Volume 1 261-262;

[226] See chapter 4 para 4 4 4.

[227] Langbein (1996) *Iowa LR* 667.

[228] 668.

> "Our traditional long-established notion that the current beneficiary automatically receives all the 'income' has concealed from us the truth that the trustee's investment policy largely determines how much that income will be."

5 2 2 The duty of impartiality

Trustees are obliged to treat beneficiaries impartially unless the terms of the trust instrument show that the founder had a different intention.[229] This duty can be referred to as the "duty of impartiality" or the "duty to be even-handed".[230] At the first level, the duty of impartiality requires trustees to "exercise fairness as between each beneficiary, showing no favour to any one";[231] and at the second level, the duty requires trustees to act even-handedly as between different classes of beneficiaries.[232] The focus of the discussion in this section is only on the second level of the duty of impartiality.

The duty of impartiality requires trustees to maintain a careful balance between income and capital growth when investing and managing a trust's investment portfolio:[233]

> "One of the challenges faced by most trustees in the investment of trust funds is achieving a proper balance between capital and income. The duty to be evenhanded requires a trustee to balance income and capital growth."

Maintaining a proper balance between income and capital is not a difficult task when all trust beneficiaries are both income and capital beneficiaries.[234] However, treating beneficiaries impartially becomes particularly difficult when income and capital beneficiaries have competing interests.[235] The clearest example of a situation in which trustees have difficulty in acting impartially arises where the trust is in favour of two or more persons with successive interests.[236] For example, a fairly common

[229] De Waal (1999) *TSAR* 375-376.
[230] 375-376; *Griessel NO v De Kock* 2019 (5) SA 396 (SCA) para 17.
[231] Hudson *Equity and Trusts* 357.
[232] De Waal (1999) *TSAR* 375-376.
[233] New Zealand Law Commission *A Trusts Act for New Zealand* 73.
[234] British Columbia Law Institute *Modernization of the Trustee Act - Total Return Investing by Trustees* (2001) Report 16 4; Ontario Law Reform Commission *Report on the Law of Trusts* 262.
[235] Hudson *Equity and Trusts* 359.
[236] Ontario Law Reform Commission *Report on the Law of Trusts* 262.

situation involves a deceased spouse who creates a trust to provide for the payment of income to the surviving spouse for life, with the trust capital to be distributed to the testator's issue at the death of the income beneficiary.[237] Since the testator has made an unconditional award of trust capital to the capital beneficiaries, the capital beneficiaries obtain a vested right to the trust capital upon the testator's death. Such a vested right will, however, only become enforceable upon the income beneficiary's death.[238] This type of trust, in which trustees are directed to hold the capital and pay the income to the income beneficiary (or beneficiaries), is hereafter referred to as a "traditional net-income trust".[239]

The problem that the trustees of a traditional net-income trust face is how to balance the potentially conflicting interests of income and capital beneficiaries fairly. Income beneficiaries want to see the highest return of income, whereas capital beneficiaries wish to ensure the maximum possible capital appreciation.[240] With this in mind, one can thus understand why Wolf describes the duty of impartiality as "one of the most difficult duties" imposed on trustees.[241]

5 2 3 Traditional approaches to managing beneficiaries' conflicting interests

There are two ways that trustees can attempt to manage the conflicting interests of income and capital beneficiaries: first, trustees can invest with a view to balancing income and capital returns (the "balanced approach"); or second, trustees can allow the income beneficiaries' needs to dictate asset allocation (the "income-focused approach").

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[237] Medlin (2008) *Real Prop Prob & Tr J* 735; Schanzenbach & Sitkoff (2009) *ACTEC LJ* 323 footnote 74.

[238] Du Toit et al *South African Trust Law* 174.

[239] A Werker "The percentage trust: uniting the objectives of the life tenant and remainderperson in total return investing by trustees" (2006) 25 *Est Tr & Pensions J* 329 331.

[240] TR Batson "Net income with make-up charitable remainder unitrusts and the trustee's power to adjust under Indiana's Uniform Principle and Income Act" (2012) 45 *Indiana LR* 841 848; Ontario Law Reform Commission *Report on the Law of Trusts* 262.

[241] RB Wolf "Defeating the duty to disappoint equally – the total return trust" (1997) 32 *Real Prop Prob & Tr J* 45 49.

5 2 3 1 The balanced approach

Under the balanced approach, trustees create an investment portfolio consisting of an even mix of fixed-income investments and equities. The aim is to weight the portfolio to provide a fair return for the income and capital beneficiaries.[242] For example, assume that the value of the investment portfolio of a trust is R10 million and that a fair return for income beneficiaries is 6% and a fair return for capital beneficiaries is 5%. Assuming fixed-income investments will average 6%, equities will average 9%, and the inflation rate for the period will be 5%, under the balanced approach, the income beneficiaries will receive an annual income of R300 000[243] and the capital beneficiaries will receive capital appreciation of R450 000.[244]

Not only will the trustees fail to produce the income beneficiaries' desired income of R600 000,[245] but they will also fall short (although not by much) on protecting the capital from inflation.[246] Under the balanced approach, therefore, both categories of beneficiaries are likely to be dissatisfied.[247] Wolf characterises this result as trustees' duty to disappoint equally:[248]

> "All the trustee can do is to try to fulfill their duty of impartiality by disappointing income and remainder beneficiaries equally!"

5 2 3 2 The income-focused approach

Under the income-focused approach, the needs of income beneficiaries dictate the trust's asset allocation.[249] The following example illustrates the disadvantages of this approach: suppose the trustees of a traditional net-income trust consult with the income beneficiaries. After discussing the income beneficiaries' budgetary needs, the trustees determine that 75% of the trust's investment portfolio should be allocated to fixed-income investments in order to fund the income beneficiaries' targeted cash flow for the current year. The remainder will be allocated to growth-

[242] 51; Medlin (2008) *Real Prop Prob & Tr J* 732.
[243] R10 000 000 × 50% × 6% = R300 000.
[244] R10 000 000 × 50% × 9% = R450 000.
[245] R10 000 000 × 6% = R600 000.
[246] Capital had to appreciate with R500 000 (R10 000 000 × 5%) in order to stay in line with inflation.
[247] British Columbia Law Institute *Total Return Investing by Trustees* 5.
[248] Wolf (1997) *Real Prop Prob & Tr J* 72.
[249] 49.

oriented investments. Assume fixed-income investments will average 6%, equities will average 9%, and the inflation rate for the period will be 5%. Assuming an initial value of R10 million, the trustees' investment activity will generate an income of R450 000[250] and capital appreciation of R225 000.[251]

While the R450 000 income received by the income beneficiaries is more than the R300 000 they can receive under the balanced approach, it is still less than the income beneficiaries' desired income of R600 000. But it is the capital beneficiaries especially that will have good reason to complain. They are in a far worse position under the income-focused approach than the balanced approach. Trust capital only grew with R225 000, while it had to grow with at least R500 000 in order to protect its purchasing power.[252]

The income-focused approach clearly favours the interests of the income beneficiaries and compromises the interests of the capital beneficiaries.[253] The New Zealand case *Re Mulligan (deceased)*[254] can be used to illustrate the problem with favouring income beneficiaries.[255] The trust founder's widow, Mrs Mulligan, was both a trustee and an income beneficiary. Mrs Mulligan was able to intimidate her co-trustee (a trustee corporation) into joining her in an investment strategy that was designed to maximise income. The investment strategy thus favoured her but at the expense of the capital beneficiaries. After her death, the capital beneficiaries sued both Mrs Mulligan and the trustee corporation for breach of trust, and were successful in their action. The trustees were held liable to make up the decline in capital value suffered by the trust fund. In the case of Mrs Mulligan, the liability to make restitution fell on her estate.[256]

5 2 4 Preferential treatment of beneficiaries

There are occasional instances where a founder's chief interest is the income beneficiary (or beneficiaries), and where concern for the capital beneficiaries is

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[250] R10 000 000 × 75% × 6% = R450 000.

[251] R10 000 000 × 25% × 9% = R225 000.

[252] R10 000 000 × 5% = R500 000.

[253] Collins & Stampfli (2001) *ACTEC J* 206.

[254] (1998) 1 NZLR 481.

[255] Mitchell *Hayton and Mitchell Law of Trusts* 389.

[256] 389; Manns (1998) *Victoria U Wellington LR* 616 footnote 21; *Re Mulligan (deceased)* (1998) 1 NZLR 481 481-483 and 512.

therefore secondary. For example, the founder wants his spouse, should he predecease her, to live out her days with the same degree of comfort she has enjoyed prior to his death. In order to achieve this result, the founder provides in the trust instrument that the trustees should produce sufficient income to maintain the surviving spouse's lifestyle, even if it requires an increasing tilt towards fixed-income investments.[257] The lack of capital growth will be acceptable under these circumstances since the duty of impartiality is overridden by the terms of the trust.

The founder in this example should, however, be advised that such an investment strategy will not only harm the capital beneficiaries' interests, but will also ultimately compromise the interests of the income beneficiary. Fixed-income investments provide a good rate of income, but their market value is static. Fixed-income investments thus provide no prospect for capital growth.[258] Therefore, an investment strategy designed purely to maximise income would not preserve the real value of trust capital. Although the preservation of the real value of capital has obvious importance to capital beneficiaries, it is also important to income beneficiaries. Halbach explains that safeguarding the real value of capital is important because it protects the purchasing power of the income flow of income beneficiaries over the years.[259] Founders considering an investment strategy skewed toward income production rather than capital growth should, therefore, bear in mind that such a strategy will inevitably not generate sufficient income to meet the future maintenance needs of the income beneficiaries.[260]

5 2 5 Conclusion

The combination of the traditional distribution rule and the duty of impartiality makes it exceedingly difficult for trustees to protect the real value of trust capital and to ensure that adequate income is produced continuously. Three trust scenarios are presented to support this claim: first, the balanced approach neither generates adequate income nor does it protect the real value of trust capital. Second, the income-focused approach provides more income to income beneficiaries than the balanced approach, but at the expense of the interest of the capital beneficiaries.

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[257] Medlin (2008) *Real Prop Prob & Tr J* 735.

[258] British Columbia Law Institute *Total Return Investing by Trustees* 4.

[259] Halbach (1992) *Real Prop Prob & Tr J* 443.

[260] *Administrators, Estate Richards v Nichol* 1999 1 SA 551 (SCA) 556F-G.

The pursuit of such an investment strategy constitutes a breach of trustees' duty of impartiality and beneficiaries can hold trustees liable for the decline in trust capital. Third, where the founder has excluded the duty of impartiality and the trustees decide to follow an investment strategy designed purely for maximising income, the value of trust capital will not be preserved and the trustees will eventually not be able to generate sufficient income to meet the income beneficiaries' maintenance needs.

5 3 The solution to the problem

An investigation of the trust law in each of the comparable foreign jurisdictions reveals that the solution to the problem identified in the preceding paragraph is legislative reform, which would enable trustees to operate total return investing. The term "total return investing" requires explaining.

A key principle of MPT is that it is artificial to distinguish between income and capital when investing.[261] Instead, MPT assesses investment options based on its overall total return regardless of whether the investments are categorised correctly as income or capital.[262] This approach is referred to as "total return investing" in chapter 4.[263] The traditional distribution rule and the duty of impartiality, when taken together, limit the ability of trustees to apply this principle of MPT and invest for total return. For example, trustees cannot invest 100% of a trust's investment portfolio in equities and distribute 50% of the profit from the sale of appreciated stock to income beneficiaries because income beneficiaries are only entitled to trust income. Nor can trustees invest 100% of the investment portfolio in fixed-income investments in order to meet the income beneficiaries' needs since such an investment policy violates trustees' duty of impartiality.

In order to enable trustees in South Africa to invest for total return, legislation should permit trustees to disregard the distinction between income and capital in certain circumstances. This is the only change to present law that is required. No changes are required to the duty of impartiality. The duty of impartiality retains its validity as a general principle under a total return investing regime.[264]

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[261] Begleiter (1999) *Maine LR* 59; New Zealand Law Commission *Review of the Law of Trusts – Preferred Approach* (2012) Issues Paper 31 95.

[262] Gordon (1987) *N Y U LR* 99-100; Werker (2006) *Est Tr & Pensions J* 331.

[263] See chapter 4 para 4 4 4.

[264] British Columbia Law Institute *Total Return Investing by Trustees* 5.

The effect of total return investing reform will be that investment decision-making will be separated from distributional issues. In other words, trustees will no longer have to select investments based on the legal category of the returns received.[265] Once total return investing has been implemented, trustees will, as a first step, invest for maximum overall return, and then, in a separate and subsequent step, allocate the return as fairly as possible.[266]

The promise of total return investing is that, if implemented and administered correctly, it delivers a higher rate of return than an investment strategy that is required to achieve a particular income/capital allocation.[267] This promise is based on the following grounds: first, total return investing removes restrictions from trustees' choices.[268] Collins and Stampfli state that:[269]

> "In the absence of a net-income trust structure, a portfolio manager is not constrained by the task of seeking targeted amounts of accounting income. Therefore, the manager has greater flexibility to implement portfolios to generate a total return adequate to the purposes, terms, distribution requirements, and other circumstances of the trust."

Second, total return investing facilitates the proper diversification of investments.[270] Gordon observes that skewing a trust's investment portfolio to achieve a particular income/capital allocation leads to the portfolio not being diversified optimally. Diversification is impaired because the portfolio is not assembled with the objective of producing the greatest expected returns for the risk.[271] Third, a total return approach to investment places trustees in the best position to employ the risk/return analysis effectively in order to obtain the maximum advantage for the trust and to make the kind of choices that other prudent investors would make.[272] Phillips states that:[273]

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[265] New Zealand Law Commission *Review of the Law of Trusts – The Duties, Office and Powers of a Trustee* (2011) Issues Paper 26 74.

[266] Dobris (1993) *Real Prop Prob & Tr J* 412; Langbein (1996) *Iowa LR* 668.

[267] The Law Commission *Capital and Income in Trusts: Classification and Apportionment* (2009) Law Com No 315 34.

[268] 34.

[269] Collins & Stampfli (2001) *ACTEC J* 206.

[270] The Law Commission *Capital and Income in Trusts* 34.

[271] Gordon (1987) *N Y U LR* 100-101.

[272] British Columbia Law Institute *Total Return Investing by Trustees* 8.

> "[Total return investing] gives trustees greater flexibility in assessing tradeoffs between risk and reward by providing a much broader view of what constitutes return and, consequently, what justifies increased risks for the portfolio."

By providing superior returns to other investment practices, total return investing increases the likelihood of trustees being able to preserve the real value of trust capital while simultaneously providing income beneficiaries with adequate income. Total return investing, therefore, significantly increases the chances of a successful outcome for all interested parties.[274]

5 4 The different ways of facilitating total return investing

There are three ways of facilitating total return investing: first, a founder can permit the trustees to access capital; second, legislation can give trustees the power to allocate income to capital beneficiaries or capital to income beneficiaries; and third, legislation can make provision for converting certain trusts to "percentage trusts".

5 4 1 The power to access capital

The power to access capital gives trustees a discretion to invade trust capital and distribute it to income beneficiaries.[275] Typical language usually limits capital distributions to categories of need. For example, a trust may require the trustees to hold capital and pay income to the income beneficiaries, and also allow the trustees to distribute capital for the income beneficiaries' health, maintenance, education or support.[276] According to Butler, a clause of this nature makes it possible for trustees to invest on a total return basis.[277] For instance, instead of trying to maximise income flows to ensure that the needs of income beneficiaries are met, trustees can invest

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[273] Phillips (1997) *Wash & Lee LR* 355.

[274] Collins & Stampfli (2001) *ACTEC J* 217-218.

[275] Gordon (1987) *N Y U LR* 102; RW Nenno "The power to adjust and total-return unitrust statutes: state developments and tax considerations" (2008) 42 *Real Prop Prob & Tr J 657* 661.

[276] Nenno (2008) *Real Prop Prob & Tr J* 663; RB Wolf "Estate planning with total return trusts: meeting human needs and investment goals through modern trust design" (2001) 36 *Real Prop Prob & Tr J* 169 245.

[277] Butler (1995) 7 *Bond LR* 146.

for total return, and in the event that the income of the trust is insufficient, distribute capital to income beneficiaries.[278]

5 4 2 The power of allocation

The power of allocation permits trustees to allocate returns to either income beneficiaries or capital beneficiaries at the trustees' discretion.[279] There are two ways to permit trustees to use the power of allocation: first, legislation can authorise trustees to allocate income returns to capital and to allocate capital returns to income. Trustees would thus be free to use the power of allocation provided that the power to allocate is not prohibited by the trust instrument. In terms of this approach, the power of allocation is the default standard.[280] Second, a founder can insert a clause in the trust instrument giving the trustees the power of allocation. In terms of this approach, the power of allocation is on an opt-in basis.[281] Of the two options, the first approach is preferred since it makes total return investment available – not only to future trusts but existing trusts as well.

5 4 3 Percentage trusts

Under the percentage trust model, all investment gains (ie interest, dividends, and capital growth) are initially assigned to capital, thereafter a percentage of the capital is allocated to income beneficiaries.[282] Percentage trusts are familiar in the United States where they are known as "unitrusts".[283] Percentage trusts can be established either by a founder or by trustees.[284] Distributions from percentage trusts are usually first paid out of income, second from short-term capital gains, third from long-term capital gains, and lastly from trust capital. However, the governing instrument may provide a different ordering structure for distributions.[285]

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[278] W Geach & J Yeats *Trusts Law and Practice* (2007) 118.

[279] Nenno (2008) *Real Prop Prob & Tr J* 667; Werker (2006) *Est Tr & Pensions J* 339.

[280] See s 11-2.3(b)(5) of the Prudent Investor Act.

[281] The Law Commission *Capital and Income in Trusts* 57.

[282] Langbein (1996) *Iowa LR* 669.

[283] The Law Commission *Capital and Income in Trusts* 37.

[284] See para 5 5 below.

[285] CP Cline "The Uniform Prudent Investor and Principle and Income Acts: changing the trust landscape" (2008) 42 *Real Prop Prob & Tr J* 611 653.

One immediate question regarding percentage trusts is this: what should the percentage rate be? An ideal percentage rate will provide the highest income to the income beneficiaries, while also preserving the value of the capital for the eventual benefit of the capital beneficiaries. Too low a percentage rate is prejudicial to income beneficiaries, while too high a percentage rate disadvantages the capital beneficiaries and may even deplete the trust fund prematurely.[286] The percentage rate can be a fixed percentage (eg 6%), an inflation-indexed percentage (eg inflation plus 2%), or a permissible range percentage (eg 4–7%); or the percentage rate can be linked to some external benchmark such as the yield obtainable on high quality bonds or the repo interest rate.[287]

Wolf discourages the use of an inflation-indexed percentage because inflation is not correlated with return. He warns that inflation may even be inversely correlated with return. Linking the percentage rate to inflation would effectively mean that stock and bond markets will be adversely affected during a period of high inflation, and yet the distribution to the income beneficiaries would have to increase.[288] Wolf recommends that trustees should rather use a fixed percentage rate. He further recommends that the rate should not change. According to Wolf, giving trustees full discretion to determine the percentage rate annually would be burdensome rather than attractive:[289]

> "An annual requirement to select a distribution rate would be unattractive to trustees who must then make a fundamental decision about the trust at least once a year."

Wolf warns that changing rates, particularly at the extremes, affect the economics of the trust tremendously. Trustees might be tempted to pay out a higher rate when interest rates are high and a lower rate when interest rates are low.[290] Wolf explains that this is exactly contrary to good financial practice:[291]

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[286] British Columbia Law Institute *Total Return Investing by Trustees* 12.

[287] 7 and 13; Cline (2008) *Real Prop Prob & Tr J* 653; Manns (1998) *Victoria U Wellington LR* 627-628; Moffat *Trust Law* (2009) 515.

[288] Wolf (1997) *Real Prop Prob & Tr J* 73.

[289] Wolf (2001) *Real Prop Prob & Tr J* 281.

[290] 281.

[291] 281.

"High interest rates imply high inflationary expectations and typically are a companion of very low total returns, hence reflecting the very reverse of what should occur in distribution practice."

Wolf carried out computer simulations in the United States to determine the ideal percentage rate. The simulations used percentage rates ranging from 3% to 6% over the period from 1960 to 1997 and determined that the highest percentage rate that would protect both income and capital beneficiaries from inflation was 5%.[292] It is submitted that any jurisdiction that wants to prescribe a statutory default fixed percentage rate will have to carry out similar simulations.

Another question that has to be answered when considering percentage trusts is this: how should the trust portfolio be valued? A statutory regime for percentage trusts has to state that certain assets may be omitted from calculations. It further has to stipulate how often valuations should take place. As discussed in paragraph 4 6 3 3 above, in a trust portfolio where there are assets that are not being held for investment, the trust portfolio effectively consists of an investment portfolio and a non-investment component. In order to avoid any doubt, legislation should provide that in determining the net value of the trust capital, trustees may exclude assets not being held for investment from the computations.[293] Regarding how often the investment portfolio should be valued, legislation should state that valuations should take place at least once every year unless the trust instrument requires more frequent valuations.[294] It is also suggested that legislation should make provision for a three-year "smoothing rule". This means that trustees must continue to value the investment portfolio at least once a year, but can apply the percentage rate to the fair market value of the investment portfolio averaged over a three-year period.[295] The benefit of a smoothing rule is that it provides a more consistent stream of income distributions.[296]

[292] British Columbia Law Institute *Total Return Investing by Trustees* 12.

[293] Wolf (2001) *Real Prop Prob & Tr J* 276.

[294] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 74-75.

[295] The Law Commission *Capital and Income in Trusts* 37.

[296] Wolf (1997) *Real Prop Prob & Tr J* 76.

5 5 The current position in each of the comparable foreign jurisdictions

New York was the first state in the United States to take up the task of a serious analysis of the problem identified in paragraph 5 2, namely that the combination of the traditional distribution rule and the duty of impartiality limits the ability of trustees to apply total return investing. According to Wolf, while New York was the fourth state to enact total return friendly legislation, the work of New York's legislative committees produced much of the early initiative and progress in legislative analysis.[297] Today, legislation in New York makes provision for the power of allocation as the default position (as opposed to having the power of allocation on an opt-in basis).[298] Legislation further permits founders to establish percentage trusts and trustees to convert existing trusts to percentage trusts.[299]

In England, concerns regarding the law governing the treatment of capital and income in trusts were raised in 2000 during the parliamentary debates on the Trustee Bill. The matter was referred to the Law Commission of England and Wales (referred to in this section as the "English Law Commission". The English Law Commission commenced work on the project in 2003, published a Consultation Paper in 2004, and made recommendations in 2009. Six points were clear from the consultation exercise:[300] first, the English Law Commission noted in its 2009 report that the law does not prohibit a founder from establishing a power of allocation in the trust instrument or constituting a percentage trust. Second, total return investing was, however, not being employed in private trusts. In charitable trusts, on the other hand, trustees were (and still are) investing profitably on a total return basis. Third, despite total return investing not operating in private trusts, there is considerable support for it within the trust industry. The English Law Commission found that many trustees would like to invest for total return and are frustrated by the inability to do so. Fourth, of the two total return investing models, the English Law Commission preferred the percentage trust model. Fifth, the English Law Commission explained that there is, however, a significant obstacle to the widespread adoption of total return investing in

[297] Wolf (2001) *Real Prop Prob & Tr J* 177.

[298] S 11-2.3(b)(5) of the Prudent Investor Act. In New York, the power of allocation is referred to as the "power to adjust".

[299] S 11-2.4 of the Prudent Investor Act; Cline (2008) *Real Prop Prob & Tr J* 652-653.

[300] See chapter 5 para 5 5.

England. From a tax perspective, the structure of the two ways of facilitating total return investing does not map onto the current tax system. Consequently, tax considerations prevented the English Law Commission from recommending that total return investing be made available to private trusts. Sixth, despite the tax issues, the English Law Commission remained of the view that total return investing would be an important step for England. Accordingly, it recommended that more work be done in order to enable trustees to use total return investing somewhere in the future:[301]

> "Accordingly, we conclude this Part with a recommendation that HMRC [Her Majesty's Revenue and Customs] and HM Treasury [Her Majesty's Treasury] work with the trust industry to devise a mechanism for total return investment in a way that facilitates investment while remaining satisfactory from the point of view of taxation."

In New Zealand, the traditional distribution rule read together with trustees' duty of impartiality means that trustees cannot invest for total return.[302] The New Zealand Law Commission, however, proposed changes to the current position that would allow trustees to follow a total return investing approach. Both the power of allocation and the percentage trust model were considered as options to facilitate total return investment. Of the two options, the New Zealand Law Commission eventually decided to recommend the power of allocation.

The Trusts Act 2019 reflects the recommendation of the New Zealand Law Commission:[303]

> "For the purposes of distribution, and of preparing and completing a financial statement for a trust, a trustee may determine whether a return on an investment is to be treated as income or capital."

Trustees will, therefore, be able to use the power of allocation as the default position once the Trusts Act 2019 enters into force on 30 January 2021.

To summarise, the current position in each of the relevant jurisdictions is as follows: legislation in New York permits trustees to use either the power of allocation or the percentage trust model depending on the circumstances; the English Law Commission considers the percentage trust model the method most likely to be

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[301] The Law Commission *Capital and Income in Trusts* 75.

[302] For a discussion regarding the position in New Zealand, see chapter 6 para 4 3.

[303] S 60 of the Trusts Act 2019.

successful in facilitating total return investment should total return investing eventually be adopted in England; and in New Zealand, trustees will be able to use the power of allocation as the default position once the Trusts Act 2019 enters into force.

5 6 Choosing the correct method of facilitating total return investing

According to Wolf, given the great variety of situations that founders and trustees face, no one method of facilitating total return investing is suitable for every kind of trust.[304] Therefore, founders and trustees should be able to choose the option that is most fitting to the circumstances of the particular trust. Consequently, it is proposed that South Africa should follow an approach similar to that of New York. In New York, founders and trustees are in a position, depending on the circumstances, to either use the power of allocation or the percentage trust model. This raises the following question: which method of facilitating total return investing is best suited for which type of scenario? The following three scenarios are examined below in order to answer this question: first, where the income and capital beneficiaries have identical interests; second, where the income and capital beneficiaries have different interests and the trust is a discretionary trust; third, where the income and capital beneficiaries have different interests and the trust is a traditional net-income trust.

5 6 1 Scenario one: beneficiaries with identical interests

From a distributional point of view, where beneficiaries are both income and capital beneficiaries, the source of the gains flowing from trust investments is generally immaterial.[305] The Ontario Law Commission explains why the distinction between income and capital in these types of trusts is not important:[306]

> "The distinction between income and capital is not crucial where there is only one trust beneficiary; for instance, it will be a matter of indifference, tax implications aside, to a minor who will receive the property from trustees upon the attainment of majority whether gain accrues as income or capital, because he will take both. Similarly, if there is a class

[304] Wolf (2001) *Real Prop Prob & Tr J* 270.

[305] British Columbia Law Institute *Total Return Investing by Trustees* 4.

[306] Ontario Law Reform Commission *Report on the Law of Trusts* 264.

of beneficiaries, each of whom is to share in both income and capital when given circumstances occur, they will not be concerned with the form of the gain."

Therefore, trustees are automatically capable of investing for total return in circumstances in which all of the beneficiaries have identical interests.[307]

5 6 2 Scenario two: discretionary trusts

Founders often do not intend for distributions to be made on a regular basis. In many cases, founders instruct the trustees to exercise discretion with regard to the size and frequency of distributions, and the particular beneficiary or beneficiaries who are to receive benefits.[308] These trusts are commonly known as discretionary trusts.

The percentage trust model is not suitable for discretionary trusts.[309] Discretionary trusts give trustees a discretion whether to make distributions and, if so, how much. According to Du Toit et al, discretionary trusts require flexibility regarding the award of trust benefits to beneficiaries.[310] In a percentage trust, on the other hand, the way distributions are made is quite rigid: the investment portfolio is valued, a percentage of that value is allocated to income beneficiaries, and income is distributed to the beneficiaries on a recurring basis.[311]

A more flexible method of facilitating total return investing in a discretionary trust is using the power of allocation.[312] The following example serves to illustrate why the power of allocation is a suitable option for discretionary trusts. Assume that for the current year, after consulting with the income beneficiaries, the trustees determine that the income beneficiaries' future budgetary needs are R450 000. The trustees decide to distribute trust income to the income beneficiaries at the end of the year. Further assume that the value of the trust fund is R10 million and that trustees will earn 6% return on fixed-income investments and 9% return on equities, and that the inflation for the year will be 5%.

[307] Wolf (1997) *Real Prop Prob & Tr J* 96.

[308] British Columbia Law Institute *Total Return Investing by Trustees* 14; Nenno (2008) *Real Prop Prob & Tr J* 661.

[309] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 75.

[310] Du Toit et al *South African Trust Law* 198.

[311] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 74.

[312] 75.

Under the traditional approach, the trustees would have to invest 75% of the investment portfolio in fixed-income investments to generate an income of R450 000.[313] In that event, the trust capital will not grow in line with inflation. The capital will only appreciate with 2.25%,[314] while inflation for the year will be 5%.

In contrast, the trustees can achieve their income goal and come much closer to reaching their capital goal if they use the power of allocation. Assuming that the beneficiaries accept the additional risk of a high equity mix,[315] the trustees could invest the entire R10 million in equities and receive a total return of R900 000.[316] Using the power to allocate, the trustees could distribute R450 000 to the income beneficiaries and allocate the remaining R450 000 to the capital beneficiaries' account in order to offset the impact of inflation.

It is important to address a possible misunderstanding regarding total return investing at this stage. Total return investing should not be understood as always requiring an investment strategy heavily weighted toward equities. The purpose of total return investing is to free trustees to make the best possible choice concerning asset allocation and investment decisions.[317] History suggests that the long-term rate of return from equity investments has consistently been shown to exceed that of fixed-income investments.[318] Since fixed-income investments yield dramatically less than equity investments over long periods of time,[319] a compelling case can be made that the asset allocation in a portfolio intended for a long duration should favour equities. The benefit of being able to disregard the distinction between income and capital when investing is that it enables trustees to use investment strategies weighted more toward equities.

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[313] R10 000 000 × 75% × 6% = R450 000.

[314] R10 000 000 × 25% × 9% = R225 000, R225 000 / R10 000 000 = 2.25%.

[315] Wolf (2001) *Real Prop Prob & Tr J* 245; Medlin (2008) *Real Prop Prob & Tr J* 736: "… any discussion of investment strategy cannot focus only on returns. The prudent investor trustee must also consider risk …".

[316] R10 000 000 × 100% × 9% = R900 000.

[317] Wolf (1997) *Real Prop Prob & Tr J* 96.

[318] British Columbia Law Institute *Total Return Investing by Trustees* 5.

[319] Wolf (1997) *Real Prop Prob & Tr J* 51.

5 6 3 Scenario three: traditional net-income trusts

As discussed in paragraph 5 2 2, a traditional net-income trust is a trust that directs the trustees to hold the capital and pay the income to the income beneficiaries. The terms of such a trust may either require income and capital beneficiaries to be treated equally or may require one of the classes to receive preferential treatment. If there is no provision in the trust instrument addressing the issue of impartiality, the default position will apply in which case all classes of beneficiaries should be treated impartially. On the other hand, the trust instrument may require a certain class, for example, the income beneficiaries, to receive preferential treatment.

5 6 3 1 If beneficiaries should be treated impartially

As discussed in paragraph 5 4 1, it is possible for trustees to invest on a total return basis if a trust contains the power to access capital. The power to access capital is, however, not suitable for use in a traditional net-income trust that requires beneficiaries to be treated impartially.[320] Werker explains that the power to access capital does not provide trustees with any guidance as to how the power should be used in such a scenario:[321]

> "This leaves it to the trustee at a later day to muddle along; investing with the hope that it will provide a suitable income for the life tenant; encroaching on capital with little guidance as to when this is appropriate; and fearing the wrath of the remaindermen at the end of the day because the investment performance has been worse than average and branches of the tree have been intermittently lopped off to compensate."

Despite its usefulness in a discretionary trust, the power of allocation is not suitable for use in a traditional net-income trust subject to the duty of impartiality. Gordon recommends that trustees' discretion regarding the allocation of benefits in such a scenario should be as narrow as possible. He warns that the more reliance is placed on continual trustee discretion, the more opportunity beneficiaries will have to

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[320] HG Carpenter "The 'fixed-income', 'annuity' and 'modernized' types of trust" (1938) 5 *Law & Contemp Probs* 368 371.

[321] Werker (2006) *Est Tr & Pensions J* 342.

complain about an abuse of power.[322] Wolf states that most trustees of a traditional net-income trust are likely to be uncomfortable with the power of allocation, simply because they will not know how to use it.[323] According to Wolf, the power of allocation does not give trustees any kind of guidance as to what a fair and reasonable distribution of income would be.[324] The shortcoming of the approach is, therefore, that it does not remove the great difficulty for trustees of fulfilling their duty of impartiality.[325]

It is submitted, therefore, that the best way of facilitating total return investing in a traditional net-income trust is to convert the trust into a percentage trust. In a percentage trust, the trustees consider the risk tolerance of the beneficiaries, invest for total return, and pay out a percentage of the value of the investment portfolio to the income beneficiaries.[326] Accordingly, trustees have less discretion regarding the allocation of benefits than in the case of the power of allocation.[327] The advantage of keeping the question of the allocation of benefits as narrow as possible is that it provides freedom from conflict between the interests of beneficiaries. Wolf states:[328]

> "By directing the trustee to pay out a specific percentage of the trust set forth by the grantor or testator, this type of trust instrument removes the great difficulty in fulfilling the duty of impartiality."

The percentage trust model, therefore, does a number of things that no other trust can do as well: it forges a partnership between income beneficiaries and capital beneficiaries, because what is good for one is good for the other;[329] it emphasises a common goal of providing maximum return;[330] and it eliminates the burden of the

[322] Gordon (1987) *N Y U LR* 103.

[323] RB Wolf "Total Return trusts – can your clients afford anything less?" (1998) 33 *Real Prop Prob & Tr J* 131 142.

[324] Wolf (1997) *Real Prop Prob & Tr J* 73.

[325] Werker (2006) *Est Tr & Pensions J* 340.

[326] Wolf (1997) *Real Prop Prob & Tr J* 74; Collins & Stampfli (2001) *ACTEC J* 206.

[327] R Sitkoff "An agency costs theory of trust law" (2004) 89 *Cornell LR* 621 654.

[328] Wolf (1997) *Real Prop Prob & Tr J* 74.

[329] 74; Sitkoff (2004) *Cornell LR* 654.

[330] Wolf (1997) *Real Prop Prob & Tr J* 96.

trustees' duty of impartiality by directing trustees to pay out a specific percentage rate.[331]

5 6 3 2 If preferential treatment is required

There are cases where the founder instructs the trustees to produce sufficient income to maintain the lifestyle of the income beneficiaries even if it requires an investment strategy tilted toward income production rather than capital protection. The percentage trust model is not appropriate if it is apparent that the founder intends that the income beneficiaries should receive preferential treatment. Such a trust should not be converted into a percentage trust because the percentage of the investment portfolio paid to the income beneficiaries might be too low to maintain their lifestyle.[332] Where high-income payouts are required, it is suggested that trustees should still invest for total return, but that they should use more flexible methods of facilitating total return investing such as the power to access capital or the power of allocation.

5 7 Conclusion and proposed changes to legislation

The problem with the current position in South African trust law is that the combination of the traditional distribution rule and the duty of impartiality makes it extremely difficult for trustees to protect the real value of trust capital and to ensure that adequate income is produced continuously.

Three trust scenarios are presented in support of this claim: first, the balanced approach does not generate adequate income, nor does it protect the real value of trust capital. Second, the income-focused approach provides more income to income beneficiaries than the balanced approach does but at the expense of the capital beneficiaries' interests. Third, where the founder has removed the duty of impartiality and the trustees decide to follow an investment strategy designed purely to maximise income, the value of trust capital will not be preserved and the trustees will eventually not be able to generate sufficient income to meet the maintenance needs of the income beneficiaries.

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[331] 96; Werker (2006) *Est Tr & Pensions J* 341.

[332] Medlin (2008) *Real Prop Prob & Tr J* 735.

The solution to the problem is legislative reform, which would enable trustees to operate total return investing. Total return investing increases the likelihood of trustees being able to preserve the real value of trust capital while simultaneously also providing income beneficiaries with adequate income. The only change to legislation required to enable trustees to invest for total return is to disregard the distinction between income and capital. No changes to the duty of impartiality are thus required.

There are three ways of facilitating total return investing: the power to access capital, the power of allocation, and percentage trusts. Each of the relevant jurisdictions has a different view regarding which method is the most suitable way of accomplishing total return investing: legislation in New York permits both the use of the power of allocation and the creation of percentage trusts; the English Law Commission considers the percentage trust model as the method most likely to be successful in facilitating total return investment should total return investing be implemented in England; and in New Zealand, the Trusts Act 2019 reflects the recommendation of the New Zealand Law Commission that the power of allocation should be the default standard.

It is proposed that South Africa should follow an approach similar to that of New York. Given the great variety of situations that founders and trustees face, no one method of facilitating total return investing is correct for all circumstances. Therefore, founders and trustees should be able to choose the option that best suits the circumstances of the particular trust. This raises the following important question: which method of facilitating total return investing is best suited for which type of scenario? After examining four possible trust scenarios, it is concluded that:

(a) Where the income and capital beneficiaries have identical interests, the trustees are automatically capable of investing for total return.

(b) In a discretionary trust where the income and capital beneficiaries have different interests, the most suitable method of facilitating total return investing is the power of allocation.

(c) In a traditional net-income trust where the income and capital beneficiaries have different interests and beneficiaries should be treated impartially, the most suitable way of facilitating total return investing is to convert the trust to a percentage trust.

(d) In a traditional net-income trust where the income and capital beneficiaries have different interests and preferential treatment is required, more flexible methods of facilitating total return investing should be used such as the power to access capital or the power of allocation.

Accordingly, in order to enable trustees to invest for total return it is proposed that two subsections, subsection (6) and (7), be added to the newly proposed section 9A of the Trust Property Control Act. Subsection (6) will give statutory recognition to the power of allocation, while subsection (7) will make provision for the creation of percentage trusts. It is proposed that subsection (6) of section 9A should read as follows:

> "For the purposes of distribution, and in the absence of any contrary indication in the trust instrument, a trustee may in the trustee's discretion allocate a return on an investment, whether income or capital in nature, either to the income beneficiaries or the capital beneficiaries."

In terms of subsection (6), the power of allocation is the default standard and the trustees of both existing and future trusts will thus have the ability to use the power of allocation. However, since the subsection is subject to any contrary indication in the trust instrument, founders can opt out of any total return investing regime.

It is further proposed that subsection (7) of section 9A should read as follows:

> "A founder may establish a percentage trust or, absent any contrary indication in the trust instrument, a trustee may convert an existing trust into a percentage trust. Once a percentage trust has been created, a trustee must –
>
> (a) valuate the trust assets at least once every year unless the trust instrument requires more frequent valuations; and
>
> (b) pay the income beneficiaries the percentage rate specified in the trust instrument, or if no percentage is specified, the percentage rate as per the regulations published by Government Notice.
>
> Once a percentage trust has been created, a trustee may –
>
> (a) exclude from calculations trust assets not being held for investment; and

(b) apply the specified percentage rate to the trust assets averaged over a three-year period."

The proposal is, therefore, that trustees must apply the percentage rate found in the trust instrument; however, if a rate is not specified, trustees should use a fixed percentage rate. The rate will not be fixed by statute but rather by regulation. Computer simulations will have to be carried out in order to determine the ideal percentage rate. It is expected that the simulations will suggest that the percentage rate ought to be 5%.[333]

Section 9A(7) would introduce a new term, namely a "percentage trust" into existing legislation. This term, absent the contextualisation and explanations contained in the dissertation, requires elucidation in the statute. Therefore, it is proposed that the following definition of a percentage trust be added to section 1 of the Trust Property Control Act:

"Percentage trust means a trust in which all investment gains are initially assigned to trust capital and then at a later stage a percentage of the capital is allocated to income beneficiaries."

Finally, the Prudent Investor Act in New York provides a list of factors that trustees should consider before creating a percentage trust or exercising the power of allocation.[334] These factors closely resemble the considerations found in subsection (4) of section 9A (which lists the circumstances that trustees should consider before making investment decisions).[335] It is, therefore, unnecessary to repeat the list under the subsections dealing with total return investing.

6 The delegation of investment functions

6 1 Introduction

The purpose of this section is to discuss the fifth area of trustee investment affected by the implementation of MPT, namely the delegation of trustees'

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[333] This percentage rate is based on the average inflation rate in South Africa over the past 10 years: Anonymous "CPI inflation in South Africa" (30-01-2020) *Inflation.eu* <https://www.inflation.eu/inflation-rates/south-africa/historic-inflation/cpi-inflation-south-africa.aspx/> (accessed 30-01-2020) 1.

[334] See ss 11-2.3(b)(5)(B) and 11-2.4(e)(5)(A) of the Prudent Investor Act.

[335] See para 3 5 above.

investment functions. The section begins by describing the current position in South African trust law regarding the delegation of investment functions. Thereafter, the section discusses the problem with our current position and explains why in most cases relying on the advice of investment experts is not the solution to the problem. Following this discussion, the section briefly reviews the different approaches to the delegation of investment functions in each of the comparable foreign jurisdictions. The second-last part of the section presents the suggested solution to the problem and explains why the solution offers adequate protection to the interests of trust beneficiaries. The section concludes with a summary, which is accompanied by proposals of how legislation should change to enable trustees to delegate investment functions to someone with the necessary investment expertise.

6 2 The position in South Africa

In terms of South African common law, trustees have a general authority to delegate administrative functions to others.[336] Trustees may thus take fundamental decisions relating to a trust and delegate the implementation of such decisions to, for example, a co-trustee or a suitable qualified professional person.[337] In such instances, trustees must exercise oversight and will remain liable for any losses resulting from the actions of the person to whom a task was delegated.[338]

On the other hand, trustees cannot in terms of our common law delegate "fundamental decisions" and "fundamental discretionary power" to others.[339] Since making investment decisions requires the exercise of discretion,[340] trustees cannot delegate such decisions to someone else. Trustees are generally, therefore, not entitled to delegate investment functions to another. This rule is hereafter referred to as the "non-delegation rule".[341]

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[336] *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para 24; *Allan v Erlank's Trustee* 1908 TS 1187 1193.

[337] *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para 24; Cameron et al *Honoré's Law of Trusts* 387-388.

[338] *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para 24; Cameron et al *Honoré's Law of Trusts* 390.

[339] *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) paras 24 and 26.

[340] *Jowell v Bramwell-Jones* 1998 1 SA 836 (W) 894; SM Dickson "Trust administration in Georgia and the prudent investor rule: may trustees delegate their investment powers?" (1997) 14 *Georgia St U LR* 633 640.

[341] Schwartzel (2002) *Baylor LR* 804.

Notwithstanding the aforementioned, it can be argued that in light of the decision in *Hoosen NO v Deedat*[342] ("*Hoosen*"), it would be legally permissible for trustees to delegate investment functions to someone else if certain conditions are met. Before discussing these conditions, it is helpful first to discuss the facts of *Hoosen*.

6 2 1 The facts in Hoosen

In *Hoosen*, one of the trustees of a trust suffered a stroke, which left him paralysed from the neck down and unable to speak. Despite his physical disability, he remained of sound mind and was able to communicate with the help of a computer-aided communication system. However, because of his disability, he was incapable of attending meetings of the trustees and performing his related duties as trustee.[343] He granted a special power of attorney to his daughter-in-law "to act on [his] behalf and in [his] name and place" at all meetings as she "may deem fit".[344] The trustee effectively transferred his powers and duties as trustee to his daughter-in-law, which amounted to "a delegation of the trustee's judgement and discretion in relation to the decision-making powers of the trust".[345]

The Supreme Court of Appeal had to decide whether the trustee was entitled to delegate his judgement and discretion to his daughter-in-law.[346] The court held that the trust instrument did not expressly authorise delegation of this nature. The court further held that the trust instrument left no room for such authorisation to be implied.[347] The daughter-in-law, therefore, was interdicted from acting in terms of the power of attorney.[348]

Two considerations strengthened the court's finding against an implied authorisation of the delegation of the trustee's judgement and discretion: first, the collective nature of the trustees' duties and the general prohibition against the delegation of a fundamental discretionary power; and second, the principle that a trustee whose appointment was occasioned by particular personal attributes and

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342 1999 (4) SA 425 (SCA).

343 *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para 3.

344 Para 8.

345 *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para 14; Cameron et al *Honoré's Law of Trusts* 389.

346 *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para 7.

347 Para 29; Du Toit et al *South African Trust Law* 137.

348 Cameron et al *Honoré's Law of Trusts* 389.

skills is generally not allowed to delegate his functions to someone who does not possess that same attributes and skills.[349] The trust at issue was established in the interests of the Muslim community in order to propagate and promote the Islamic faith. The court, therefore, concluded that the trustees of the trust must be "people imbued with the spirit of Islam who could be relied upon to give effect to the objects of the trust".[350] According to Du Toit et al, this requirement militated against any delegation of trustee functions to "someone who was not likewise positioned to fulfil the trust's objects".[351]

6 2 2 The conditions for the delegation of investment functions

In light of the *Hoosen* decision, it is submitted that trustees may delegate investment functions if the following conditions are met: first, the trust instrument must authorise the trustees to delegate their judgement and discretion. In *Hoosen*, the court stated that a delegation of this nature was neither expressly nor impliedly permitted by the trust instrument.[352] This statement can be interpreted to mean that in a case in which the delegation of trustees' judgement and discretion is expressly authorised in the trust instrument, such delegation may indeed be permitted. Support for this interpretation of the statement in *Hoosen* is found in *Van Wyk v Daberas Adventures CC*[353] ("*Daberas*"). In this more recent case, Olivier J stated that for trustees to have the right to delegate fundamental decisions and fundamental discretionary power, such a power would have to be expressly provided for in a trust instrument:[354]

> "In my view these findings in the Hoosen case pertained specifically to the delegation of '*fundamental decisions'* and of '*fundamental discretionary power'*. The right to delegate such a power would have to be expressly provided for in a trust deed and, if not, it will not readily be implied." [Olivier J's emphasis.]

[349] *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para 26; Du Toit et al *South African Trust Law* 137.

[350] *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para 27.

[351] Du Toit et al *South African Trust Law* 137.

[352] *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para 29.

[353] 2018 ZANCHC 01-06-2018 case no 1431/2016.

[354] *Van Wyk v Daberas Adventures CC* 2018 ZANCHC 01-06-2018 case no 1431/2016 para 28.

Second, the decision to delegate investment functions must not be taken by an individual trustee but by the trustees acting as a collective.[355] A clear principle in South African trust law is that trustees must act jointly.[356] This is known as the "joint-action rule".[357] In terms of this rule, all decisions by co-trustees must be taken unanimously.[358] However, a trust instrument may allow decisions to be made otherwise; for example, by majority vote.[359] Therefore, the decision to delegate investment functions must not be taken by an individual trustee but by the entire trustee complement. Depending on the provisions of the trust instrument, the decision may either be taken by a unanimous vote or by way of a majority vote.

Third, trustees wishing to delegate their investment functions must not be selected specifically for their investment knowledge and experience. The court stated in *Hoosen* that if the trustees' attributes and skills are pivotal in their selection as trustees, delegation is not allowed:[360]

> "In considering the issue one may also, by analogy, draw usefully from an established principle in the law of agency, while not losing sight of the essential differences between a trustee and an agent. That principle states that where the identity and personal attributes or skills of the performer of an act are of material importance, delegation is not permitted …"

To summarise, trustees are not allowed to delegate investment functions to others in terms of the non-delegation rule. However, the non-delegation rule does not preclude trustees from delegating investment functions if the following conditions are met: the trust instrument expressly allows such delegation; the full trustee complement decides to delegate investment functions; and the trustees of the particular trust are not selected specifically for their investment knowledge and experience.

It is submitted that, as is the case with the delegation of administrative functions, delegating investment functions will not release trustees from the duty of supervising

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[355] *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para 26.

[356] Du Toit et al *South African Trust Law* 22; MJ de Waal & I du Plessis "A comparative perspective on the 'joint-action rule' in the context of business trusts" (2014) 2 *Stell LR* 343 343.

[357] De Waal & Du Plessis (2014) *Stell LR* 343.

[358] F du Toit "Co-trusteeship and the joint-action rule in South African trust law" (2013) 27 *TLI* 18 22.

[359] Du Toit et al *South African Trust Law* 27; De Waal & Du Plessis (2014) *Stell LR* 356.

[360] *Hoosen NO v Deedat* 1999 (4) SA 425 (SCA) para *26*.

the actions of any co-trustee or non-trustee to whom the delegation has been made. Furthermore, delegating their investment functions will not relieve trustees from liability for the wrongful acts done by the delegate.

6 3 The problem with the non-delegation rule

Making sound investment decisions in today's world requires considerable knowledge and experience.[361] According to Duckworth, investment management has become a difficult and complex business:[362]

> "… the changes that have occurred in the course of this century, principally in the period since the Second World War, have turned investment management into a difficult and complex business. There are no simple answers, and there are no universal answers. The business of investment management now demands a high degree of expertise and technical support; it has spawned a diversity of theories and techniques almost as great as the diversity of investment opportunities; it is still changing rapidly; and it is a dangerous business, occasionally burning the fingers of the most expert and diligent."

The skills required to construct and manage an investment portfolio should thus not be underestimated, as the following passage illustrates:[363]

> "Managing a portfolio of marketable securities is as demanding a speciality as stomach surgery or nuclear engineering. There is no more reason to expect the ordinary individual serving as a trustee to possess the requisite investment expertise than to expect ordinary citizens to possess expertise in gastroenterology or atomic science."

Furthermore, the theory of investment management advanced in this dissertation, namely MPT, is highly sophisticated and requires a high degree of professional knowledge.[364] As discussed in chapter 3, a person investing in accordance with MPT is required to: construct a portfolio with different asset classes and adjust the asset

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[361] Dickson (1997) *Georgia St U LR* 635; Schwartzel (2002) *Baylor LR* 798.

[362] Duckworth (1997) *PCB* 22-23.

[363] JH Langbein "Reversing the nondelegation rule of trust-Investment Law" (1994) 59 *Missouri LR* 105 110.

[364] Butler (1995) *Bond LR* 134.

allocation when circumstances change; diversify the portfolio, properly using a large amount of stocks; and apply active management strategies if necessary.[365]

Given that investment management has become a difficult and complex business, trustees with no training in finance or asset management will find it extremely difficult to manage an investment portfolio of a trust in the best financial interest of the beneficiaries of the trust.[366] To ensure that persons with the necessary investment expertise make investment decisions, the jurisdictions discussed below abrogated the prohibition on the delegation of investment functions and have instead sought to encourage such delegation.[367] In South Africa, however, the non-delegation rule does not allow non-expert trustees to delegate investment functions to persons with expertise in making optimal investment decisions.

One of two things is likely to happen if MPT principles are integrated into South African trust law, but no changes to the non-delegation rule are made: first, trustees without investment expertise might become unwilling to serve as trustees for fear of being held personally liable for imprudent investment decisions;[368] second, and the more likely result, is that trustees will not employ a challenging investment strategy, such as MPT, which they do not fully comprehend.[369]

To summarise, the problem with the non-delegation rule is that it prevents trustees from pursuing rewarding investment strategies since non-expert trustees are not allowed to delegate investment functions to someone with investment expertise. Consequently, the rule would hinder trustees' use of MPT should MPT be adopted in our law since non-expert trustees would not understand MPT and would not be allowed to delegate their investment functions to someone with the necessary investment expertise.

At this stage, one might object and argue that the problem can be addressed in a simple way: trustees who lack sophistication in investment matters can seek expert

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[365] See chapter 3 para 6.

[366] Kunene (2001) *INS TAX* 1; D Hayton "English fiduciary standards and trust law" (1999) 32 *Vand J Transnat'l L* 555 564.

[367] See para 6 4 below.

[368] Sterk (2010) *Cornell LR* 903; JC Dobris "Speculations on the idea of 'speculation' in trust investing: an essay" (2004) 39 *Real Prop Prob & Tr J* 439 474 footnote 140.

[369] Dobris (2004) *Real Prop Prob & Tr J* 473; Butler (1995) *Bond LR* 137.

advice and then act on the basis of that advice.[370] The problem with relying on advice, however, is that in most cases it will effectively amount to delegation, but without the necessary safeguards in place. This statement requires explaining.

According to Schwartzel, trustees lacking the expertise to develop an investment program on their own will often lack the competence required properly to evaluate the plans that an investment advisor recommends.[371] In such instances, the trustees are relying on the advice of the advisor to the extent that investment decisions cannot be truly said to be those of the trustees.[372] Although it might seem that the trustees are making the final decision on investment selection, they are actually approving the advisor's selections without proper consideration.[373] According to Dickson, trustees often rubberstamp the advisor's decisions:[374]

> "In many cases, the agent made the investment selections, and the trustee merely 'rubberstamped' the agent's decisions."

Langbein refers to this type of delegation as "*de facto* delegation".[375] According to Langbein and Posner, *de facto* delegation takes place when:[376]

> "… the investment advisor 'recommends' and the trustee routinely 'decides' to follow the advice, the trustee in reality is delegating the selection of investments."

The main concern with *de facto* delegation is that, although delegation occurs, suitable safeguards are not in place. Suitable safeguards have to be in place in order to protect beneficiaries against imprudent delegation of investment functions.[377] The safeguards that must be complied with are discussed in paragraph 6 5 1 below.

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[370] Dobris (2004) *Real Prop Prob & Tr J* 472-473.

[371] Schwartzel (2002) *Baylor LR* 800 footnote 330.

[372] Butler (1995) *Bond LR* 135.

[373] Langbein (1994) *Missouri LR*109.

[374] Dickson (1997) *Georgia St U LR* 640.

[375] Langbein (1994) *Missouri LR* 109.

[376] JH Langbein & RA Posner "Market funds and trust-investment law" (1976) 1 *Am B Found Res J* 120.

[377] Dickson (1997) *Georgia St U LR* 657.

6 4 The current position in each of the comparable foreign jurisdictions

In New York, the Prudent Investor Act permits trustees to delegate investment functions to an investment manager.[378] Trustees are, however, required to follow very strict and specific guidelines when delegating investment functions.[379] More specifically, trustees are required to exercise care, skill and caution in selecting a suitable delegate; establish the scope and terms of authority; monitor the delegate's performance; and control overall costs by reason of the delegation.[380] According to Klein, trustees who properly delegate investment functions are not liable for the decisions of an investment manager.[381]

New York permits delegation among co-trustees. Delegation to a fellow trustee is generally acceptable where one trustee has expertise in a particular aspect of trust administration, such as investing. Yet delegation is not absolute, and delegating trustees must monitor the dealings and decisions of a delegate trustee. If a delegate trustee has acted in an irresponsible manner, the delegating trustees will not be held liable for a loss to the trust fund if they can demonstrate that their behaviour was prudent.[382]

In England, the Trustee Act 2000 provides that trustees are permitted to "authorise any person to exercise any or all of their delegable functions as their agent".[383] Section 11(2) of the Act defines delegable functions to consist of any function other than the following four exceptions: a decision regarding the distribution of trust assets; the power to decide whether fees should be payable out of income or capital; any power to appoint a person as a trustee; or any power to delegate trustee responsibilities. Trustees thus have the power to delegate investment functions by virtue of investment functions being absent from the proscribed list.[384] Investment

[378] See s 11-2.3(c) of the Prudent Investor Act. For a detailed discussion of the delegation of trustees' investment functions in New York, see chapter 4 paras 3 3 5 and 5 3.

[379] CR Radigan, JF Hillman & PK Kelly "Does New York need a trust code?" (2011) 244 *N Y LJ* 1 2.

[380] S 11-2.3(c)(1) of the Prudent Investor Act.

[381] Klein (2014) *T & T* 698. For a contrasting view, see Dickson (1997) *Georgia St U LR* 658.

[382] IM Bloom & WP LaPiana *Final Report on the EPTL-SCPA Legislative Advisory Committee's 6th Report* (2016) A-160.

[383] S 11(1) of the Trustee Act 2000. For a detailed discussion of the delegation of trustees' investment functions in England, see chapter 5 para 5 4.

[384] R Wilson "The tension between trustees and investment managers: part 1" (2003) 1 *PCB* 31 35.

functions may be delegated to an outside agent or one of the trustees themselves,[385] but not to any trustee who is also a beneficiary.[386]

Special conditions apply where trustees delegate investment functions: first, the agreement for appointing an investment manager must be in writing;[387] second, trustees must prepare a written "policy statement" giving guidance as to how the delegated functions should be exercised;[388] third, the agreement under which an investment manager is to act must contain a term ensuring the investment manager's compliance with the policy statement;[389] and fourth, having delegated their investment functions, trustees are required to keep the arrangements under which an investment manager acts under review and have to consider any power of intervention which trustees may have.[390]

Trustees will not be liable for any losses arising out of any act or default of an investment manager unless the trustees failed to comply with their duty of care in relation to the appointment and subsequent supervision of an investment manager.[391]

The current position in New Zealand is that trustees may not delegate their responsibility of selecting and holding investments to an investment manager[392] unless delegation is specifically authorised by the trust instrument.[393] Research from the New Zealand Law Commission indicates that many modern trust deeds enable trustees to delegate in such a way.[394]

New Zealand's current position will change once the Trusts Act 2019 enters into force on 30 January 2021. The New Zealand Law Commission recommended in its report on trust law that trustees should be able to appoint investment managers with

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385 De Waal & Du Plessis (2014) *Stell LR* 351; S 12(1) of the Trustee Act 2000.

386 S 12(3) of the Trustee Act 2000.

387 S 15(1).

388 Ss 15(2)(a) and 15(4).

389 S 15(2)(b).

390 S 22(1).

391 S 23(1); S Panesar "The Trustee Act 2000" (2001) 12 *ICCLR* 151 156.

392 Kelly et al *Law of Trusts* 551.

393 New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 20. For a detailed discussion of the delegation of trustees' investment functions in New Zealand, see chapter 6 para 4 2 above.

394 New Zealand Law Commission *A Trusts Act for New Zealand* 139.

the authority to make investment decisions.[395] The Trusts Act 2019 reflects these recommendations relating to the appointment of investment managers. Section 67(1) provides that trustees may:

> "… (a) appoint a person to exercise or perform, on behalf of the trustee, specified powers or functions in relation to the trust; (b) appoint a person to make specified decisions in relation to all or part of the trust property; (c) appoint an eligible person to hold or deal with all or part of the trust property as nominee or custodian and vest all or part of the trust property in that person."

According to Cone et al, section 67(1) thus provides scope for the appointment of investment managers.[396]

The New Zealand Law Commission further recommended that the appointment of investment managers should be subject to certain safeguards.[397] Based on this recommendation, the Trusts Act 2019 provides the following safeguards: first, it is mandatory for trustees to keep any delegation under review and consider whether they need to intervene at any point;[398] and second, trustees must apply the general duty of care in section 29 of the Act in appointing an investment manager.[399]

The New Zealand Law Commission was of the view that trustees should not remain liable for the actions or decisions of an investment manager:[400]

> "If a trustee has delegated investment decision-making because the trustee does not have the necessary expertise, it would seem anomalous for the trustee to remain liable for what the delegate does. If the trustee remained liable, he or she would likely feel obliged to take a much greater interest in investment matters."

Accordingly, the Trusts Act 2019 provides that trustees will not be held liable for any act or default of an investment manager unless the trustees failed to apply the legislative safeguards.[401]

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[395] 29.

[396] Cone et al (2019) *T & T* 898.

[397] New Zealand Law Commission *A Trusts Act for New Zealand* 29-30.

[398] S 68(1) of the Trusts Act 2019.

[399] S 68(2).

[400] New Zealand Law Commission *Preferred Approach* 107-108.

[401] S 69 of the Trusts Act 2019.

6 5 The solution to the problem

The proposed solution to the problem identified in paragraph 6 3 is that legislation in South Africa should allow trustees to delegate investment functions to a co-trustee with the necessary investment expertise. Furthermore, legislation should provide that as long as the delegation is proper, delegating trustees will not be liable for the actions or decisions of a delegate trustee. Delegation will be regarded as proper if the delegating trustees comply with certain legislative safeguards.[402] The proposal, therefore, is that the non-delegation rule should be abandoned and replaced with a "pro-delegation default rule".[403] Authorising trustees to delegate investment functions will allow trustees to serve beneficiaries better, since it will ensure that persons with an understanding of MPT make investment decisions.[404]

In order to determine whether a pro-delegation default rule will strike an appropriate balance between, on the one hand, the benefit that beneficiaries will receive from the delegation of investment functions and, on the other hand, the securing of adequate protection of the interests of beneficiaries, the following questions must be answered: first, which safeguards should legislation put in place? Second, should delegating trustees be liable for the actions or decisions of a delegate trustee? Third, should delegating trustees also be capable of delegating investment functions to a third party? Before answering these questions, it is helpful to first consider a typical trust scenario in which the delegation of investment functions would be beneficial to the beneficiaries of the trust.

When selecting trustees, the basic decision for a founder often comes down to choosing between a professional trustee and a "lay trustee", or sometimes a combination of the two.[405] Examples of people who can act as professional trustees are admitted attorneys, accountants, or individuals who are affiliated to a trust company.[406] Examples of lay trustees are family members or close friends.[407]

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[402] The proposed legislative safeguards are discussed in para 6 5 1 below.

[403] Dickson (1997) *Georgia St U LR* 657.

[404] Chukwu (2017) *Ann Surv Int'l & Comp L* 110.

[405] Dickson (1997) *Georgia St U LR* 650.

[406] Kelly et al *Law of Trusts* 586.

[407] Dickson (1997) *Georgia St U LR* 635; Halbach (1992) *Real Prop Prob & Tr J* 446. It should be noted that if the lay trustees are all beneficiaries of a trust, and are all related to one another, the founder must appoint an "independent trustee". An independent trustee can be a lay trustee or a

According to Dickson, the fact that trust administration may be a full-time job makes it better suited for a professional trustee.[408] However, several factors may influence a founder to appoint a lay trustee rather than a professional trustee: a lay trustee might be more familiar with the beneficiaries' circumstances; choosing a lay trustee might be less expensive than choosing a professional trustee; and a founder might trust a lay trustee more than a third party.[409] While family members and close friends of ordinary intelligence can serve as trustees, they often do not have the time or expertise to make complex investment decisions.[410] Fortunately, a compromise position exists. A founder can appoint individual trustees in joint trusteeship with a professional trustee. Having individual trustees and a professional trustee serve together gives a founder the best of both worlds, since each trustee will have his own talents and areas of expertise.[411] For example, the lay trustees might be familiar with the founder's family intricacies, while the professional trustee will have expertise in trust administration, investment of trust funds and tax matters.[412] Delegating investment functions to the professional trustee would benefit the beneficiaries, since someone with investment experience would be making investment decisions.

6 5 1 Which safeguards should legislation put in place?

According to Dickson, putting appropriate legislative safeguards in place protects beneficiaries against imprudent delegation.[413] The two main safeguards favoured by the comparable foreign jurisdictions are establishing a written policy statement and monitoring a delegate's conduct and performance.[414]

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professional trustee: Department: Justice and Constitutional Development *Trusts: Dealing with Various Trust Matters* 2017 Chief Master's Directive 2 of 2017 13-16.

[408] Dickson (1997) *Georgia St U LR* 651.

[409] 635; F du Toit "Choose your trustee with care" (2007) 15 *JBL* 91 93.

[410] New Zealand Law Commission *Preferred Approach* 106-107.

[411] Dickson (1997) *Georgia St U LR* 651; JT Brooks, WC Weinsheimer& EA Swanson "Delegation of trustee's duties to advisors" (2004) 121 *Banking LJ* 141 148.

[412] Dickson (1997) *Georgia St U LR* 635.

[413] 657.

[414] See the discussion in para 6 4 above.

6 5 1 1 Written policy statement

Legislation should provide that a written policy statement must be prepared before any delegation of investment functions occurs.[415] The purpose of a policy statement is to give a delegate trustee guidance as to how asset management functions should be exercised.[416] Wilson states that trustees must not treat the creation of a policy statement as a "once and for all" exercise:[417]

> "If the circumstances of the trust change, or they find their initial requirements to have been inappropriate, the trustees must change the policy statement."

A policy statement does not have to be a detailed document, but should at least address the following two matters: first, a policy statement should specify the desired level of risk exposure for the investment portfolio of a trust;[418] and second, a policy statement should impose reporting requirements on the delegate trustee.[419]

Trustees must consider a number of factors to determine the appropriate level of risk exposure for the portfolio. These factors are discussed in paragraph 3 5 above. Trustees should, for example, take into consideration: the size of the portfolio; the estimated duration of the trust; and the needs of the beneficiaries. Suppose that the trustees of a particular trust determine that an appropriate level of risk exposure for the trust's investment portfolio is half as much as the market exhibits as a whole. In other words, the trustees find that the investment portfolio should have a beta of 0.5.[420] As risk and return are inextricably linked, the trustees will have to accept a lower return in exchange for less risk exposure. In order to achieve the desired risk/ return combination, the portfolio will have to consist of a mix of risky assets and relatively risk-free assets. Securities with typically low betas, such as corporate or government bonds or other fixed-income securities, should thus be combined so that the portfolio has an average beta of 0.5.[421] Interestingly, by setting out the desired

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[415] New Zealand Law Commission *Preferred Approach* 106.

[416] R Wilson "The tension between trustees and investment managers: part 2" (2003) 2 *PCB* 91 96.

[417] 99.

[418] New Zealand Law Commission *Preferred Approach* 108; AW Eccles "Legislative comment investing in the future" (2006) 5 *Scots L T* 23 26.

[419] Wilson (2003) *PCB* 99; Brooks et al (2004) *Banking LJ* 143.

[420] For a discussion of beta and how to increase or decrease risk in a portfolio, see chapter 3 para 5.

[421] See chapter 3 para 5 2.

level of risk exposure in the policy statement, the trustees effectively determine the asset allocation of the portfolio. The delegate trustee, being the investment expert, should advise his fellow trustees in determining an appropriate level of risk tolerance for the portfolio, but the delegate trustee will not make the decision on asset allocation on his own. Thus, for example, a decision to invest in 60% listed shares and 40% bonds will be agreed upon by all of the trustees, while the actual shares to be acquired will be decided by the delegate trustee.

The second matter that a policy statement should address is reporting requirements. Delegating trustees should impose reporting requirements on a delegate trustee. According to Wilson, the level of information that must be provided and the frequency of reports will vary depending upon the circumstances of each trust.[422]

6 5 1 2 Monitoring conduct and performance

Legislation should require delegating trustees to monitor the conduct and performance of a delegate trustee.[423] Given the complexity of investment management, what is expected from delegating trustees in this regard is not closely to review or second-guess the decisions of the delegate trustee.[424] Instead, sufficient monitoring requires delegating trustees to consider investment reports and ensure that the delegate trustee complies with the terms of the policy statement.[425] It is recommended that delegating trustees should meet with the delegate trustee at least twice a year to discuss the trustee's performance, or hold a special meeting if there are special circumstances (eg when performance changes substantially).[426] If performance is clearly inadequate, the delegate trustee must provide reasons for the poor performance and satisfy his co-trustees that steps are in place to meet investment goals. If the trustee is given a reasonable opportunity and is still unable to meet expectations, the remaining trustees should replace the delegate trustee.[427]

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[422] Wilson (2003) *PCB* 99.

[423] Klein (2014) *T & T* 698.

[424] New Zealand Law Commission *Preferred Approach* 107.

[425] 107; Brooks et al (2004) *Banking LJ* 144.

[426] Klein (2014) *T & T* 698.

[427] New Zealand Law Commission *Preferred Approach* 107; Wilson (2003) *PCB* 97.

6 5 2 *Should delegating trustees be liable for the actions or decisions of a delegate trustee?*

This part begins by explaining the problem with holding a delegating trustee who complied with the proposed legislative safeguards liable for the actions or decisions of a delegate trustee. Thereafter, the current position in South African trust law regarding the liability of co-trustees is examined to determine how, if at all, the law should change.

According to the New Zealand Law Commission, if delegating trustees remain liable for the actions or decisions of a delegate trustee, they will likely feel obliged to take a much greater interest in investment matters.[428] Delegating trustees are, however, not capable of reviewing or second-guessing the decisions of a delegate trustee.[429] After all, the entire reason why delegation would take place is because delegating trustees usually lack investment skills.[430] The New Zealand Law Commission summarises the point being made here as follows:[431]

> "If a trustee has delegated investment decision-making because the trustee does not have the necessary expertise, it would seem anomalous for the trustee to remain liable for what the delegate does."

Allowing delegating trustees to be more involved in investment matters places the delegate trustee in a very difficult situation. Assume, for example, that the delegating trustees and the delegate trustee of a particular trust disagree over an investment strategy. Since the delegating trustees do not understand the delegate trustee's proposed strategy, they insist on a less complex investment strategy. The delegate trustee has two options: he could obey the delegating trustees' instruction, which is against his own advice; or if he is unwilling to violate his duty to the beneficiaries to make the best possible investment decisions, he can resign as trustee. Either way, the consequence of maintaining liability is that the skill and judgement of professional investment manager will not be fully utilised,[432] and the delegate trustee

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[428] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 78.

[429] New Zealand Law Commission *Preferred Approach* 107.

[430] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 78.

[431] 78.

[432] Sterk (2010) *Cornell LR* 855; New Zealand Law Commission *Preferred Approach* 105.

is prevented from pursuing a potentially rewarding investment strategy.[433] In conclusion, delegating trustees should not be liable for the actions or decisions of a delegate trustee because maintaining liability "defeats the purpose of delegation".[434]

The question to be addressed next is whether delegating trustees who are innocent of any wrongdoing or neglect (hereafter referred to as "innocent" delegating trustees) will in terms of current trust law be held liable for the wrongful acts of a delegate trustee.[435] This question will be answered by examining the exact nature of a co-trustee's liability in South African trust law.

In *Gross v Pentz*[436] ("*Gross*"), the Supreme Court of Appeal conceded that the precise position in South African law regarding the liability of co-trustees for breach of trust "is not altogether clear".[437] The facts of *Gross* need not be discussed here; suffice it to say that the case dealt primarily with the question whether a trust beneficiary had *locus standi* to institute legal proceedings for the recovery of a loss to the trust estate as a consequence of an alleged breach of trust by one of the trustees.[438] Unfortunately, the court did not find it to be the appropriate occasion to provide more clarity on the liability of co-trustees.[439] According to De Waal, the court suggested *obiter* that a trustee who had been innocent of any wrongdoing or neglect would nevertheless be liable for a breach of trust committed by other trustees.[440] The court added, however, that a re-evaluation of South African law "could result in a relaxation of the rule".[441]

De Waal published an article in 1999 that focused on the issue that the court in *Gross* found unnecessary to address.[442] According to De Waal, the case law on the joint and several liability of co-trustees for breach of trust points strongly to the

[433] Halbach (1992) *Real Prop Prob & Tr J* 421.

[434] Dickson (1997) *Georgia St U LR* 655.

[435] The term "innocent of any wrongdoing or neglect" appears in *Gross v Pentz* 1996 (4) SA 617 (A) 630H.

[436] 1996 (4) SA 617 (A).

[437] *Gross v Pentz* 1996 (4) SA 617 (A) 629C.

[438] 618A; MJ de Waal "The liability of co-trustees for breach of trust" (1999) 1 *Stell LR* 21 21.

[439] *Gross v Pentz* 1996 (4) SA 617 (A) 630H.

[440] De Waal (1999) *Stell LR* 22-23.

[441] *Gross v Pentz* 1996 (4) SA 617 (A) 630G-H; De Waal (1999) *Stell LR* 23.

[442] De Waal (1999) *Stell LR* 23.

operation of the fault principle.[443] As a result, co-trustees will be held liable for breach of trust only if fault, even if only in the form of negligence, is attributable to them:[444]

> "Therefore, a trustee can only be held liable for a breach of trust if fault, even if only in the form of negligence, can be proved. Neither authority nor policy considerations suggest that a different approach should be followed in the case of co-trustees."

On this basis, it is submitted that South African courts will not hold innocent delegating trustees liable for the wrongful acts of a delegate trustee. However, it would provide greater certainty to delegating trustees if legislation clearly states that trustees who have complied with the proposed legislative safeguards will not be held liable for any wrongful acts.

6 5 3 Should delegating trustees be allowed to delegate investment functions to a third party?

This part clarifies why it is proposed that delegating trustees should only be allowed to delegate investment functions to a co-trustee, but not to a third party. Under this heading, delegation to a co-trustee will be referred to as "internal delegation" and delegation to a third party as "external delegation".

An example of external delegation is trustees who delegate investment functions to an outside investment manager. The concern raised by Radigan et al regarding external delegation is that an investment manager is not under a fiduciary duty of any kind to the beneficiaries, but is only required to reasonably comply with the terms of the delegation.[445] Stated differently, an investment manager owes duties to trustees, but not to beneficiaries.[446] In order to provide beneficiaries with adequate protection, a possible solution is to make an investment manager responsible to beneficiaries.[447] In other words, legislation could create duties running directly between an investment manager and beneficiaries. It is submitted, however, that there is a much simpler solution: trustees should delegate investment functions to a

[443] 30-31; Du Toit et al *South African Trust Law* 114.
[444] De Waal (1999) *Stell LR* 31.
[445] Radigan et al (2011) *N Y LJ* 2.
[446] Schwartzel (2002) *Baylor LR* 804.
[447] See 805 and Phillips (1997) *Wash & Lee LR* 379.

co-trustee, since a co-trustee, in the same way as all other trustees, is already subject to an array of statutory and common law duties. For example, trustees must, among other things: keep trust property separate from private property; adhere to the terms of the trust instrument; exercise independent judgement and discretion; and avoid conflicts of interest between their private affairs and their official functions as trustees.[448] Furthermore, the proposed South African prudent investor rule will impose additional duties on trustees, specifically relating to the management of a trust's investment portfolio. Trustees will be obliged, among other things, to: exercise the care, diligence and skill that a prudent investor would exercise in similar circumstances;[449] pursue an overall investment strategy in accordance with the level of risk and return reasonably suited to the entire trust portfolio;[450] and properly diversify assets unless the trustees reasonably determine that it is in the interest of the beneficiaries not to diversify.[451]

6 6 Conclusion and proposed changes to legislation

In terms of South African common law, trustees have a general authority to delegate *administrative functions* to others. Trustees are generally, however, not entitled to delegate *investment functions* to someone else. This rule is referred to as the non-delegation rule. However, it can be argued that in light of the decision in *Hoosen* it would be legally permissible for trustees to delegate investment functions if the following conditions are met: first, the trust instrument must expressly allow such delegation; second, the full trustee complement must decide to delegate investment functions; and third, trustees must not be selected specifically for their investment knowledge and experience.

The problem with the non-delegation rule is that it prevents trustees from pursuing rewarding investment strategies, since non-expert trustees are not permitted to delegate investment functions to someone with investment expertise. Furthermore, should MPT be implemented in South African trust law, the non-delegation rule would prevent trustees from implementing such an investment strategy because the rule would not allow non-expert trustees to delegate investment functions to

[448] Du Toit et al *South African Trust Law* 128-132.

[449] See para 2 5 above.

[450] See para 3 6 above.

[451] See para 4 7 above.

someone with an understanding of MPT. This problem cannot simply be addressed by consulting with experts and acting on their advice. In most cases, relying on advice will amount to *de facto* delegation. Delegation would thus occur, but without the necessary safeguards in place. As discussed above, beneficiaries' interests are not adequately protected if proper safeguards are not in place.

In contrast to the general position in South African trust law, trustees in New York and in England are permitted to delegate their investment functions. As a general rule in New Zealand, trustees are not allowed to delegate investment functions to investment managers. Yet research from the New Zealand Law Commission indicates that many modern trust deeds permit such delegation. Furthermore, New Zealand's current position will change once the Trusts Act 2019 enters into force.

The proposed solution is to abandon South Africa's non-delegation rule and replace it with a "pro-delegation default rule" that enables trustees to delegate investment functions to a co-trustee with investment expertise. Furthermore, legislation should provide that as long as the delegation is proper, delegating trustees will not be liable for the wrongful acts of a delegate trustee. Delegation will be regarded as proper if delegating trustees comply with certain legislative safeguards.

Accordingly, in order to enable trustees to delegate investment functions to a co-trustee, it is proposed that three subsections, namely subsections (8), (9) and (10), be added to the newly proposed section 9A of the Trust Property Control Act.[452] Subsection (8) will authorise trustees to delegate investment functions to a co-trustee, subsection (9) will put appropriate safeguards in place, and subsection (10) will provide that delegating trustees will not be liable for the actions or decisions of a delegate trustee. It is proposed that subsection (8) of section 9A should read as follows:

> "Unless provided for otherwise in a trust instrument, trustees may delegate investment functions to a co-trustee with the necessary investment expertise."

Subsection (9) should state the following:

> "In delegating investment functions under subsection (8), trustees are required to –
>
> (a) provide a written policy statement; and

[452] For a discussion of section 9A, see para 2 5 above.

(b) monitor the performance of the delegate trustee."

Subsection (10), which deals with the liability of delegating trustees, should read as follows:

> "Delegating trustees are liable for a loss in the value of trust assets caused by an act or omission of a delegate trustee only if the delegating trustees are in breach of subsection (9)."

Under the proposed pro-delegation default rule, delegation is not only permitted, but it is also encouraged (although not required). In small trusts, therefore, trustees could obtain expert advice and make investment selections themselves as long as relying on advice does not amount to *de facto* delegation taking place. The proposed changes will further not prevent founders from prohibiting the delegation of investing functions in trust instruments.

Section 9A(9) would introduce a new term, namely a "policy statement" into existing legislation. This term, absent the contextualisation and explanations contained in the dissertation, requires elucidation in the statute. Therefore, it is proposed that the following definition of a policy statement be added to section 1 of the Trust Property Control Act:

> "Policy statement means a document that gives a delegate trustee guidance as to how asset management functions should be exercised."

It is submitted that authorising trustees to delegate investment functions to a co-trustee who possesses the necessary investment expertise will allow trustees better to serve beneficiaries, since it will ensure that persons with an understanding of MPT make investment decisions.

7 The anti-netting rule

7 1 Introduction

The purpose of this section is to discuss the sixth area of trustee investment affected by the implementation of MPT, namely the balancing of investment gains against investment losses in the event of a breach of trust. As have been observed in previous chapters,[453] a discussion of this particular area of trustee investment requires giving specific consideration to the application of the anti-netting rule.

The first part of the section explains the way the anti-netting rule operates, discusses the reason why the anti-netting rule should form part of South African trust law, and addresses the criticism of the anti-netting rule. Next, the section briefly reviews how the rule is applied in each of the comparable foreign jurisdictions. The second-last part of the section evaluates the application of the rule in South African trust law, explains the problem with the rule as it is currently operates, and presents the solution to this problem. The section concludes with a summary, which is accompanied by proposals of how legislation should change in order to give a complete and comprehensive anti-netting rule statutory recognition in our law.

7 2 The nature, basis and criticism of the anti-netting rule

7 2 1 Introduction

The anti-netting rule provides that where a court finds that trustees have invested imprudently, the trustees cannot offset the loss from such an investment against the gains from any other source. More specifically, trustees cannot balance a loss arising from a breach of trust against a gain from another breach of trust, or against a gain from an investment not involving a breach of trust.[454] The anti-netting rule can also be referred to as the "rule against balancing losses against gains"[455] or the "no-netting rule".[456]

The anti-netting rule has an exception: if two or more breaches of trust are connected, the trustees are only accountable for the net gain or loss.[457] Stated differently, the anti-netting rule does not apply if two or more breaches of trust are not "separate and distinct".[458] The factors that are likely to be helpful in determining whether two breaches are connected are discussed later in paragraph 7 3.

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[453] See chapter 4 para 4 4 4, chapter 5 para 5 6, and chapter 6 para 3 4.

[454] Butler (1995) *Bond LR* 129; Gordon (1987) *N Y U LR* 97; Schwartzel (2002) *Baylor LR* 820.

[455] Gordon (1987) *N Y U LR* 96.

[456] Halbach (1992) *Real Prop Prob & Tr J* 457.

[457] Mowbray et al *Lewin on Trusts* 1567.

[458] LC Ipsen "Trends in the liability of corporate fiduciaries" (1988) 24 *Idaho LR* 443 450; Schwartzel (2002) *Baylor LR* 820.

Before proceeding to an example illustrating the application of the anti-netting rule, it is first necessary to explain the concept of "loss". Loss is the amount necessary to restore a trust's investment portfolio to the value it would have achieved if proper administration had taken place.[459] The amount necessary to restore the portfolio is calculated by determining the difference between the profit that would have been made by authorised investments (hereafter referred to as the "potential profit") and the profit or loss that was actually made from unauthorised investments (hereafter referred to as the "actual profit or loss"). The two examples that follow illustrate how to determine potential profit. In the first example, the trustees receive clear instructions on how to invest; in the second example, the trust instrument does not provide the trustees with specific instructions.

Example one: suppose that the terms of a particular trust require the trustees to invest the trust's initial R10 million trust fund in bonds. Despite this clear instruction, the trustees decide to invest only 50% of the trust fund in bonds and the other 50% in the stock of a listed company. After five years, the value of the bonds is R6 700 000 and the value of the stock is still R5 000 000. The bonds thus appreciated R1 700 000 in value, representing a compound annual return of around 6%, while the stock did not appreciate in value. Assume that the beneficiaries of the trust institute an action against the trustees and that the court finds that the trustees invested outside the scope of their authority with respect to the stock investment and thus acted in breach of trust.

In the present example, determining the profit that would have been made by an authorised investment is rather straightforward. The court can use the investment in bonds as a benchmark and thus assume a compound annual return of 6%. Since no actual profit was made, the loss on the stock investment is R1 700 000.[460] Ignoring the application of the anti-netting rule for now, the beneficiaries of the trust would thus have a claim of R1 700 000 against the trustees.

Example two: suppose that the trustees of a particular trust neglect to invest the trust's initial R10 million trust fund. Further suppose that the trust instrument does not state how trust funds should be invested. Due to bank costs and no significant interest rate on the trust's bank account, the trust fund is still worth R10 million after

[459] *Sasfin (Pty) Ltd v Jessop* 1997 (1) SA 675 (W) 688D-E; *Jowell v Bramwell-Jones* 1998 (1) SA 836 (W) 894J-895A.

[460] R1 700 000 (potential profit) - R0 (actual profit or loss) = R1 700 000.

five years. Assume that the beneficiaries of the trust institute an action against the trustees and that the court finds that the trustees have committed a breach of trust for failing to invest the trust's funds properly.

In order to restore the trust's portfolio to the value it would have been if proper investment had taken place, the court must consider how the trustees would have invested had the trustees invested according to the prudent investor rule. The court, with the help of expert testimony, must determine what an appropriate level of risk exposure for the trust would have been five years ago.[461] By determining the appropriate level of risk exposure, the court effectively determines what the trust's asset allocation should have been.[462]

Assume that the court concludes that the trust's portfolio should have had a beta of 0.5 (ie half as much volatility as the market as a whole exhibits) and that the trustees should have invested 50% of the portfolio in listed shares and 50% of the portfolio in bonds.[463] In order to determine the return that the portfolio would likely have earned, the court would as a next step have to determine the actual shares and bonds that the trustees would have acquired.[464] According to Hudson, the practical difficulty lies in demonstrating that the trustees would have chosen shares and bonds that would have realised a large profit as opposed to shares and bonds that would have realised a lower profit. Hudson states:[465]

> "… it would be impossible to know precisely which shares would have been acquired and, because different shares would make different levels of profit, it would be impossible to demonstrate with exactitude the extent of the trust's loss."

The suggested solution to this problem is to use a bond index fund and a market index fund to estimate the loss.[466] If one assumes that a portfolio with an allocation of 50% in a bond index fund and 50% in a market index fund would have grown at a compounded annual return of 8%, the portfolio would have appreciated to about

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[461] Schwartzel (2002) *Baylor LR* 813.

[462] See para 6 5 1 1 above.

[463] For discussion of "beta", see chapter 3 para 3 2 1.

[464] Schwartzel (2002) *Baylor LR* 813.

[465] Hudson *Equity and Trusts* 463.

[466] 463 footnote 210. For an explanation of the terms "bond index fund" and "market index fund", see chapter 3 para 5.

R14 700 000 in value after a five-year term. Loss as a result of the trustees' breach of trust is thus R4 700 000.[467]

7 2 2 Application of the anti-netting rule

Having explained the concept of loss, the application of the anti-netting rule can now be considered. Suppose that the trust instrument of a particular trust requires the trustees to invest the trust's initial R10 million fund solely in bonds. Despite this clear instruction, the trustees decide instead to invest R5 000 000 in the stock of company "X" and R5 000 000 in the stock of company "Y". After five years, the stock of company X has decreased in value to R4 000 000 and the stock of company Y has increased in value to R10 million. Assume that the beneficiaries of the trust institute an action against the trustees and that the court finds that the trustees invested outside the scope of their authority and thus acted in breach of trust.

Before applying the anti-netting rule, the court must first determine the loss on each investment. The present example is similar to example one, discussed under the preceding heading, in that the trustees received a clear instruction to invest in bonds.[468] However, unlike in example one, the trustees did not invest a portion of the trust fund in an investment that can serve as a yardstick by which the performance of the other investment can be measured. It is suggested, therefore, that the court should use a bond index fund to calculate the loss.[469]

Assuming a compound annual interest rate of 6% on a bond index fund, each investment should have increased in value to at least R6 700 000. As discussed, loss is the difference between the potential profit and the actual profit or loss.[470] In the present example, no loss is suffered on the investment in the stock of company Y since the investment outperformed the bond index fund, while a loss of R2 700 000 is suffered on the investment in the stock of company X.[471]

Having determined the loss occasioned by the breach of trust, the next step is to establish whether the two investments are connected or rather separate and distinct

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[467] R4 700 000 (potential profit) – R0 (actual profit or loss) = R4 700 000.

[468] See para 7 2 1 above.

[469] See para 7 2 1 above.

[470] See para 7 2 1 above.

[471] The difference between the potential profit of R1 700 000 and the actual loss of R1 000 000 is R2 700 000.

transactions. Should the court find that the two transactions are connected, the anti-netting rule's exception would apply and the trustees would be permitted to net the gain from the investment in the stock of company Y and the loss from the investment in the stock of company X. The beneficiaries would thus not have a claim against the trustees since the net effect is positive.[472] Consequently, after the two unauthorised investments have been realised, the trustees would have R14 000 000 to reinvest in an authorised manner.[473]

On the other hand, should the court find that the two transactions are not connected, the anti-netting rule would not permit the trustees to balance gains and losses. The beneficiaries would therefore be entitled to the R5 000 000 profit arising from the investment in the stock of company Y and may recover the loss of R2 700 000 resulting from the investment in the stock of company X.[474] Consequently, after the two investments have been realised, the trustees would have R16 700 000 available for reinvestment in bonds.[475]

7 2 3 Justification for the anti-netting rule

At first glance, it might appear that the application of the anti-netting rule may lead to rather harsh consequences for trustees. In the preceding example, for instance, despite one of the investments in the trust outperforming the bond index fund by quite a large margin, the court found that the trustees are still liable for an amount of R2 700 000.[476] There are, however, good reasons why the anti-netting rule should form part of trust law in South Africa: the rule deters trustees from committing additional breach of trust; it deters trustees from speculating with certain parts of the portfolio; and it deters trustees from carelessly investing trust funds. This statement requires further explanation.

In a jurisdiction that does not accept the anti-netting rule, trustees are able to offset investment gains in the trust against their personal liability for wrongful

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472 R5 000 000 (gain on investment Y) – R2 700 000 (loss on investment X) = R2 300 000.

473 R10 000 00 (value of investment Y) + R4 000 000 (value of investment X) + R0 (amount recovered from the trustees) = R14 000 000.

474 Kelly et al *Law of Trusts* 824.

475 R10 000 00 (value of investment Y) + R4 000 000 (value of investment X) + R2 700 000 (amount recovered from the trustees) = R16 700 000.

476 See para 7 2 2 above.

investments. The trustees are, in other words, capable of using investment gains to their own advantage. As a result, some trustees may be inclined to commit breaches of trust under certain circumstances. For example, trustees whose misconduct has caused a loss could commit additional breaches of trust in an effort to recoup the prior loss;[477] trustees could speculate with certain parts of a trust's investment portfolio in an attempt to achieve excessively high returns while safely investing other parts;[478] or trustees could be careless in investing trust funds since they have a safety net in that they are able to escape liability if certain parts of the trust portfolio perform well.[479]

The anti-netting rule holds that gains or profits in a trust do not belong to the trustees; they belong to the trust.[480] Therefore, gains are not the trustees' to offset against their personal liability for wrongful investments.[481] Bloom and LaPiana in their report on trusts and estate laws in New York express this principle as follows:[482]

> "… a trustee who has harmed the trust by a breach of duty cannot be allowed to use to his own advantage investment 'fruits' that the terms of the trust have earmarked for the beneficiary."

Justification for the anti-netting rule thus lies in the fact that the rule discourages trustees from committing breaches of trust in the circumstances mentioned above.

7 2 4 Criticism of the anti-netting rule

The anti-netting rule has been criticised as being at odds with MPT. More specifically, some authors and academics argue that the rule is an uneasy fit with one of the central ideas of MPT, namely the total portfolio approach.[483] As discussed earlier in the chapter, the total portfolio approach provides that investment decisions must not be considered in isolation, but rather in the context of a trust's investment

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[477] Gordon (1987) *N Y U LR* 97.
[478] Schwartzel (2002) *Baylor LR* 831.
[479] British Columbia Law Institute *Report on Trustee Investment Powers* (1999) BCLI Report 14, available at: <https://www.bcli.org/project/trustee-investment-powers> (accessed 13-03-2020).
[480] KL Hirsch "Inflation and the law of trusts" (1983) 18 *Real Prop Prob & Tr J* 601 631.
[481] Langbein & Posner (1976) *Am B Found Res J* 25.
[482] Bloom & LaPiana *Final Report* A-210.
[483] See Hirsch (1983) *Real Prop Prob & Tr J* 632, Ipsen (1988) *Idaho LR* 450 and Schwartzel (2002) *Baylor LR* 822.

portfolio as a whole and as a part of an overall investment strategy.[484] According to Hirsch, the anti-netting rule is in conflict with the total portfolio approach because the rule compels trustees to consider investment decisions in isolation:[485]

> "… [the anti-netting rule] embodies the tendency inherent in the prudent-man rule to consider investment decisions in isolation rather than as a part of a portfolio strategy."

Consequently, as maintained by Hirsch, trustees must worry constantly that if some of their investments fail, they will be held personally liable in spite of a record of overall success.[486]

It is submitted, however, that such criticism of the anti-netting rule is without merit. The rule is not inconsistent with the total portfolio approach since the rule is only triggered after a breach of trust has occurred.[487] Halbach emphasises that the rule serves only to measure damages and not to measure the prudence of investment decisions:[488]

> "… the no-netting rule is not involved in determining *whether* there has been a breach but only in determining the measure of damages when breaches do occur." [Halbach's own emphasis.]

Since the anti-netting rule has no bearing on gains and losses from ordinary investments where no breach of trust has taken place, trustees do not have to be concerned that a court will view every investment that the trustees made in isolation.

In conclusion, the anti-netting rule should not be seen as standing in the way of MPT or the total portfolio approach.[489]

[484] See para 3 2 above.

[485] Hirsch (1983) *Real Prop Prob & Tr J* 632.

[486] 633.

[487] Phillips (1997) *Wash & Lee LR* 365.

[488] Halbach (1992) *Real Prop Prob & Tr J* 457.

[489] J Getzler "Fiduciary investment in the shadow of financial crisis: was lord Eldon right? (2009) 3 *J Equity* 1 67.

7 3 The current position in each of the comparable foreign jurisdictions

In New York law, there is presently no statute that deals with the anti-netting rule. The rule does, however, prevail in New York case law.[490] The rule was stated in *Matter of Buck*[491] as follows:[492]

> "[A] gain realized by the retention of certain securities may not be employed to offset a loss occasioned by the retention of other securities to which objection has been made. A trustee who is liable for a loss resulting from a breach of trust with respect to one portion of the trust property cannot reduce his liability by reason of a gain with respect to another portion of the trust property occasioned by a separate and distinct breach of trust."

Two observations regarding this statement can be made: first, the anti-netting rule is accepted in full in New York law since a loss from a breach of trust cannot be offset by either gains from investments not involving a breach of trust, or from gains involving a breach of trust. Support for this observation is found in Bloom and La Piana's Final Report where they state:[493]

> "… a trustee who has harmed the trust by a breach of duty cannot be allowed to use to his own advantage investment 'fruits' that the terms of the trust have earmarked for the beneficiary …"

A second observation is that the words "separate and distinct breach of trust" seem to indicate that the exception to that anti-netting rule is recognised in New York law. As recalled, the exception to the anti-netting rule provides that if multiple breaches are connected, the trustees are only accountable for the net gain or loss.[494] According to Moffat, the difficulty lies in deciding what constitutes a connected breach of trust.[495] Certainty on this point is important since clear guidelines will make it difficult for trustees to prove that a connected breach of trust took place in order to reduce or escape their liability. The commentary to the Restatement (Third) describes four factors that are likely to be helpful in determining whether two or more

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[490] Bloom & LaPiana *Final Report* A-210.

[491] 55 N.Y.S.2d 841 (Sur. Ct. Westchester Co. 1945).

[492] *Matter of Buck* 55 N.Y.S.2d 841 (Sur. Ct. Westchester Co. 1945) 843-844.

[493] Bloom & La Piana *Final Report* A-210 and A-211.

[494] See para 7 2 1 above.

[495] Moffat *Trust Law* 504.

breaches of trust are connected. The factors that the commentary deems worth considering are as follows: first, whether the breaches of trust arose out of a single investment policy; second, the length of time that elapsed between the breaches; third, whether between the breaches of trust the trustees became aware of the earlier breach and the resulting loss; and fourth, whether the trustees intended to commit a breach of trust.[496]

In England, if a court finds that trustees have invested imprudently, the trustees cannot offset the loss from such an investment against a gain from another breach of trust,[497] or offset the loss against a gain from an investment not involving a breach of trust.[498] The anti-netting rule is thus accepted in its entirety in English law. Furthermore, the exception to the anti-netting rule applies in English law.[499] A case that illustrates the operation of the anti-netting rule's exception is *Bartlett v Barclays Bank*[500] *Trust* ("*Bartlett*").[501] In that case, there were two property development projects: one was the Old Bailey project, which was a failure; the other project was the Guildford development on which a substantial profit was made.[502] Both of these projects were undertaken in breach of trust.[503] Brightman J found that although the projects were two separate transactions, they "stemmed from exactly the same policy".[504] As a result, Brightman J held that it was permissible to offset the loss on the Old Bailey project against the profit realised on the Guildford development.[505]

In New Zealand, section 13Q of the Trustee Act 1956 (as amended) implicitly revokes the anti-netting rule,[506] while section 129(2) of the Trusts Act 2019, once it comes into force, will expressly revoke the rule.[507] In this regard, the position in New

[496] Schwartzel (2002) *Baylor LR* 822 footnote 419.
[497] Hudson *Equity and Trusts* 876; Mowbray et al *Lewin on Trusts* 1567.
[498] Moffat *Trust Law* 504.
[499] 504.
[500] (1980) 2 W.L.R. 430.
[501] For a discussion of the facts in *Bartlett v Barclays Bank Trust* (1980) 2 W.L.R. 430, see chapter 5 para 3 2.
[502] Hudson *Equity and Trusts* 876.
[503] *Bartlett v Barclays Bank Trust* (1980) 2 W.L.R. 431.
[504] 447.
[505] 431; Moffat *Trust Law* 504.
[506] New Zealand Law Commission *Preferred Approach* 93.
[507] For a detailed discussion of the way that the anti-netting rule has been dealt with in New Zealand, see chapter 6 paras 3 4 and 4 4.

Zealand differs markedly from the positions in New York and England in that the latter two jurisdictions accept and apply the anti-netting rule, whereas legislation in New Zealand is designed to overcome the effect of the rule.

In its investigation into the law of trusts, the New Zealand Law Commission came to the conclusion that the anti-netting rule is in conflict with MPT.[508] Consequently, the Law Commission recommended that the anti-netting rule should expressly be abolished.[509] Its recommendation led to the inclusion of section 55 in the Trusts Bill 2016, which later became section 129 in the Trusts Act 2019. Section 129(2) of the Act reads as follows:[510]

> "The court may set off all or part of the loss resulting from the investment against all or part of any gain resulting from any other investment whether in breach of trust or not."

Exploring the reasons for the New Zealand Law Commission's conclusion that the anti-netting rule is in conflict with MPT is not particularly meaningful. As discussed in chapter 6, when reading the Law Commission's report, it becomes apparent that the authors of the report did not fully appreciate the distinction between the anti-netting rule and the isolation approach.[511] The Law Commission's position thus derives from an incorrect understanding of the nature and extent of the anti-netting rule.

7 4 The position in South Africa

The anti-netting rule is partially accepted in South African trust law. According to Cameron et al:[512]

> "A loss in one transaction carried out in breach of a trustee's duty cannot be set off against a gain made in another distinct transaction in breach of trust."

The second part of the anti-netting rule – the part that deals with a loss carried out in breach of trust netted off against a gain from an investment *not involving a breach of trust* – is not mentioned. Before discussing the problem with this omission, it

[508] New Zealand Law Commission *The Duties, Office and Powers of a Trustee* 73.

[509] New Zealand Law Commission *A Trusts Act for New Zealand* 28.

[510] S 129(2) of the Trusts Act 2019.

[511] See chapter 6 para 4 4.

[512] Cameron et al *Honoré's Law of Trusts* 430.

should be pointed out that the exception to the anti-netting rule finds application in our law. Cameron et al states:[513]

> "However, if there is a breach of trust that results in a loss as well as a gain, the net effect upon the trust should be looked at to see whether there is a loss to be made good."

Returning to the issue of partial acceptance of the anti-netting rule, the problem is that it allows delinquent trustees to escape liability if certain parts of a trust's investment portfolio perform well. Consequently, there is no deterrent against carelessness in managing an investment portfolio since trustees who have made a loss out of an unauthorised investment can balance the loss against a gain from an authorised investment, and if the net effect is positive, the trustees would benefit from their own imprudence.[514]

To illustrate this point, consider the following example: suppose that the terms of a particular trust require the trustees to invest the trust's initial R10 million fund solely in bonds. Despite this clear instruction, the trustees decide to invest only 50% of the trust fund in bonds and 50% in the stock of company "Z". After five years, the value of the investment in bonds has increased to R6 700 000 and the value of the stock of company Z is still R5 000 000. Accordingly, the beneficiaries of the trust decide to institute an action against the trustees.[515] Assume that the court finds that the trustees committed a breach of trust with respect to the stock investment and that the loss on the investment is R1 700 000.[516]

The fact that the beneficiaries can prove that a breach of trust occurred does not of itself mean that there will be any recoverable loss. Since the second part of the anti-netting rule does not form part of South African trust law, the trustees are entitled to offset the gain from the investment in bonds against the loss from the

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[513] 430.

[514] British Columbia Law Institute *Trustee Investment Powers* 14.

[515] For present purposes, assume that the beneficiaries have a vested right to the income and capital of the trust and that the action that is instituted to recover damages is the so-called "direct action": see Du Toit et al *South African Trust Law* 185.

[516] See the calculation at para 7 2 1 above.

investment in the stock of company Z.[517] Seeing that there is no loss, the court will not award compensation.[518]

It is submitted that it is unfair, viewed from the beneficiaries' perspective, that the trustees can escape personal liability for their mistakes simply because other parts of a trust's investment portfolio performed well. In order to discourage trustees from managing an investment portfolio carelessly and negligently, it is proposed that the anti-netting rule should be accepted in its entirety in South African trust law. To be more specific, the proposal is that the Trust Property Control Act should contain a complete and comprehensive anti-netting rule similar to the rule found in English and New York law.

7 5 Conclusion and proposed changes to legislation

The anti-netting rule provides that trustees cannot balance a loss arising from a breach of trust against a gain from another breach of trust or against a gain from an investment not involving a breach of trust. An exception to the anti-netting rule is carved out for situations described as connected breaches of trust. In such cases, the trustees are only accountable for an investment portfolio's net gain or loss.

At first glance, it might appear that the application of the anti-netting rule may lead to rather harsh consequences for trustees. However, the rule's inclusion in South African trust law is justified since it deters trustees from: committing additional breaches of trust; speculating with certain parts of a trust's investment portfolio; and investing trust property carelessly.

Some authors and academics criticise the anti-netting rule as being at odds with MPT. More specifically, they argue that that the rule is an uneasy fit with one of the central ideas of MPT, namely the total portfolio approach. Such criticism is, however, without merit. The rule only comes into effect after a breach of trust has occurred and thus has no bearing on gains and losses from ordinary investments where no breach of trust has taken place. The anti-netting rule should, therefore, not be viewed as being in conflict with MPT or the total portfolio approach.

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[517] R1 700 000 – R1 700 000 = R0.

[518] In South Africa, the principal civil remedy against a trustee for failure to fulfil his duty properly is an Aquilian action for breach of trust. To succeed in an Aquilian action, the claimant must prove that a financial loss has occurred as a result of the trustees' breach of trust: Cameron et al *Law of Trusts* 427 and 429.

The anti-netting is accepted in its entirety in New York and English trust law. In contrast, legislation in New Zealand is designed to overcome the effect of the anti-netting rule. Exploring the reasons why the position in New Zealand differs from the positions in New York and England is not particularly meaningful, since New Zealand's position derives from an incorrect understanding of the nature and extent of the anti-netting rule. Having explained the benefits and the importance of the rule, the position in New York and England is preferred over the position in New Zealand.

The anti-netting rule's exception can be applied in both New York and England trust law, but is, of course, not applicable in New Zealand. Clear guidelines on what constitutes a connected breach of trust are essential because the guidelines prevent trustees from proving that a connected breach of trust took place in order to reduce or escape their liability. The section identifies four factors that are likely to be helpful in determining whether two or more breaches of trust are connected. These factors are included in the proposed legislation discussed below.

An examination of South Africa trust law indicates that the anti-netting rule is only partially accepted and that the exception to the rule finds application. Partial acceptance of the rule means that the second part of the anti-netting rule – the part that deals with a loss carried out in breach of trust netted off against a gain from an investment *not involving a breach of trust* – does not form part of our trust law. The problem with this omission is that it allows delinquent trustees to escape liability if certain parts of a trust's investment portfolio perform well. In order to discourage trustees from committing breaches of trust, it is proposed that the anti-netting rule should be accepted in its entirety in South African trust law. To be more specific, the proposal is that the Trust Property Control Act should contain a complete and comprehensive anti-netting rule similar to the rule found in English and New York law.

As far as practical implementation is concerned, it is proposed that the following two subsections, namely subsections (11) and (12), be included in the newly proposed section 9A of the Trust Property Control Act.[519] Subsection (11) will implement the anti-netting rule in its entirety as well as make provision for the rule's exception, while subsection (12) will list the factors that a court could take into

[519] For background to section 9A, see para 2 5 above.

consideration in determining whether two breaches are connected. It is proposed that subsection (11) of section 9A should read as follows:[520]

> "Losses from a breach of trust cannot be offset by either gains from investments not involving a breach of trust, or gains from other breaches of trust; unless those other breaches are connected."

It is proposed that subsection (12) should read as follows:

> "Whether or not two or more breaches of trust are connected depends on the following factors –
>
> (a) whether the breaches of trust are the result of a single policy, judgement, or set of interrelated decisions;
> (b) the length of time that elapsed between the breaches of trust;
> (c) whether, between the breaches of trust, the trustees became aware of the earlier breach, and particularly of a resulting loss or profit; and
> (d) whether the trustees intended to commit a breach of trust."

[520] See Schwartzel (2002) *Baylor LR* 820.

CHAPTER 8 – CONCLUSION

1 Introduction

The main research questions posed at the start of this dissertation were: first, should trustees' investment functions in South African law be modernised through the implementation of an investment rule based on modern portfolio theory ("MPT")? Second, if the answer to the first question is yes, what should the core features of such an investment rule be? In order to answer the main research questions, chapter 1 further posed the following four additional and more specific questions:

(a) Question 1: what is the principal problem that trustees face when they are unable to rely on an investment rule based on MPT?

(b) Question 2: is an investment strategy based on MPT the best possible approach for people managing other people's assets?

(c) Question 3: which areas of trustee investment would be most affected by integrating MPT principles into trust law?

(d) Question 4: how should these areas of trustee investment be amended in South African trust law in order to accommodate MPT?

The findings and recommendations of the dissertation are compiled in this chapter in an attempt to answer the main research questions and the four additional questions. The chapter commences by answering the four additional questions. Thereafter, the main research questions are answered. The chapter then gives a summary of the proposed amendments to the Trust Property Control Act 57 of 1988 ("Trust Property Control Act"). The chapter concludes with recommendations for further research.

2 The additional and more specific questions to the main research questions

2 1 Question 1: what is the principal problem that trustees face when they are unable to rely on an investment rule based on MPT?

The rule that governs how trustees should exercise their investment functions in South Africa is the prudent and careful person rule. The rule was enunciated in

Sackville West v Nourse[1] ("*Sackville West*"), and in *Administrators, Estate Richards v Nichol*[2] ("*Estate Richards*") it was confirmed that the rule has not been departed from since. Trustees' main investment objective when following the rule is to protect the real value of trust capital and ensure that an adequate income is produced continuously.[3]

Chapters 4 to 6 revealed that this is also what is expected from trustees in the comparable foreign jurisdictions. In terms of New York's prudent investor rule, trustees owe a duty of caution to beneficiaries. This duty requires trustees to invest with a view to both preserve the real value of trust capital and to secure a reasonable return.[4] In England, trustees are under an obligation to preserve the real value of a trust fund (as opposed to merely seeking to protect its nominal value) and, because of trustees' duty of impartiality, they are also obliged to produce a reasonable income for income beneficiaries.[5] Trustees in New Zealand are required to allocate a fair rate of return to income beneficiaries and not allow a trust fund to reduce in value.[6] It is important to point out that all three jurisdictions had to change their law from a prudent man type of rule to an investment rule based on MPT in order to meet the challenge of protecting the real value of capital and producing an adequate income.

The question raised in chapter 2 is whether it is possible for trustees to achieve their main investment objective without being able to rely on an investment rule based on MPT. The conclusion reached after examining the development of trustees' investment standards in the comparable foreign jurisdictions is that it is exceedingly difficult – if not impossible – to meet this goal under a prudent man or similar type of rule. Longstreth confirms this conclusion where he states:[7]

> "For managers subject to the prudent man rule in one form or another – fiduciaries we will call them – the task of meeting the challenges and exploiting the opportunities is much more difficult."

[1] 1925 AD 516.

[2] 1999 1 SA 551 (SCA).

[3] See chapter 2 para 4.

[4] See chapter 4 para 5 4 3.

[5] See chapter 5 para 5 5.

[6] See chapter 6 paras 4 3 and 5.

[7] B Longstreth *Modern Investment Management and the Prudent Man Rule* (1986) 3.

Therefore, to answer question 1 of the additional questions, the principal problem that trustees face when they are unable to rely on an investment rule based on MPT is that they cannot achieve their main investment objective, namely to protect the real value of capital and produce adequate income. Chapter 4 revealed the reason why it is such a challenging task to achieve this objective under a prudent man type of rule. This is because a prudent man type of rule is not capable of adapting to "changing times" (eg rising inflation) and "changing notions of investment opportunity and risk taking" (eg the findings of MPT).[8]

2 2 Question 2: is an investment strategy based on MPT the best possible approach for people managing other people's assets?

MPT is a theory of investment that attempts to maximise the expected portfolio return for a given amount of portfolio risk or equivalently minimise the risk for a given level of expected return by carefully choosing the proportions of various assets.[9] The advantage of MPT is that a careful application of its principles allows an investor to achieve reasonably good returns with a greater degree of security than is possible under other models of investment behaviour. The main reason for the greater security under MPT is because of the theory's emphasis on diversification, or to be more precise, its emphasis on the "right kind" or "proper" diversification. In order to reduce a portfolio's overall risk, MPT requires an investor to combine investments that do not go up and down in value at the same time. Chapter 3 demonstrated that this type of diversification is highly effective in reducing risk without reducing expected return.[10]

In most cases, professional investment managers are required to ensure an appropriate risk level in light of the needs of their clients and are obliged to be risk averse. Risk aversion means that a risk-averse investor will choose the less risky investment when given two investment portfolios that offer the same level of return. Chapter 3 illustrated that the risk of a diversified portfolio is lower than the risk of a non-diversified portfolio. Consequently, a risk-averse investment manager will choose a diversified portfolio. In doing so, the investment manager is able to provide

[8] See chapter 4 para 4 2 2.

[9] See chapter 3 para 1.

[10] See chapter 3 para 3 1 4.

his client with good returns and a greater degree of security than is possible under other theories of investment.[11] Therefore, the answer to the question posed in the heading above is yes, an investment strategy based on MPT is the best possible approach for a person managing someone else's assets. Furthermore, chapters 4 to 6 confirmed this last statement by showing the benefits of trustees using MPT strategies when investing and managing the assets of trust beneficiaries.

2 3 Question 3: which areas of trustee investment would be most affected by integrating MPT principles into trust law?

A number of key principles are at the centre of MPT: first, MPT defines what constitutes return using the concept of total return; second, MPT maintains that when managing an investment portfolio the focus should be on the total portfolio and not the individual investments; third, according to MPT, no asset or investment technique is inherently good or bad or prohibited *per se* as too risky; fourth diversification is essential to the management of risk.[12]

Chapters 4 to 6 illustrated that while the introduction of these principles into trust law affects many areas of trustee investment, six particular areas are affected most prominently. These six areas are summarised below.

2 3 1 Trustees' choice of investments

As mentioned in the preceding paragraph, one of the tenets of MPT is that no asset or investment technique is inherently good or bad, or prohibited *per se* as too risky. The basis for this tenet is the finding of MPT that it is possible to reduce a portfolio's risk in appropriate circumstances by adding an investment that is risky in itself. The full integration of MPT into trust law, therefore, requires wide powers of investment as opposed to limiting trustees to narrow categories of investment or prohibiting them from investing in speculative investments.

This principle has been integrated in the trust law of all three of the comparable foreign jurisdictions. Whereas New York's old prudent man rule warned trustees to avoid speculative investments, New York's prudent investor rule authorises trustees to invest in any type of investment, since no particular investment is inherently

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[11] See chapter 3 para 7.

[12] See chapter 3 para 7.

prudent or imprudent.[13] The primary obstacle to implementing MPT in England was the fact that trustee investment was limited to only certain types of investment. The Trustee Act 2000 successfully removed this obstacle by conferring the widest possible investment powers on trustees.[14] In New Zealand, the legal list approach was abolished and replaced with a provision that empowers trustees to invest in any investment.[15]

Importantly, all three jurisdictions established safeguards to act as a counterbalance to trustees' wide powers of investment. First, any form of investment should only be permissible provided that proper care, diligence and skill are employed.[16] Second, trustees are given greater flexibility in choosing investments, provided that the overall investment plan is prudent and that any additional investments advance the overall investment plan. A trust's overall investment plan is viewed as prudent if trustees invest at a level of risk-and-return that is suitable for the particular trust.[17] New investments are viewed as advancing the overall investment plan if these investments are employed in a manner that reduces the overall risk of the trust portfolio or allow the trust to achieve a higher return expectation without a disproportionate increase in the overall level of portfolio risk.[18]

2 3 2 The evaluation of a trust's investment portfolio

One of the most basic tenets of MPT is the maxim that the riskiness of an asset cannot be determined in isolation, but can be usefully determined only within the context of the overall risk of the portfolio to which the asset is added. Integrating this principle of MPT into trust law requires trustees' investment decisions to be evaluated – not in isolation, but in the context of the trust's investment portfolio as a

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[13] See chapter 4 para 5 3.

[14] See chapter 5 para 4.

[15] See chapter 6 para 3 1. See also s 58 of the Trusts Act 2019: "A trustee may invest trust property in any property".

[16] See s 11-2.3(b)(2) of the Prudent Investor Act; s 1 of the Trustee Act 2000; and s 13B of the Trustee Act 1956 (as amended) and s 29 of the Trust Act 2019.

[17] In order to determine what would be regarded as a suitable level of risk-and-return, trustees must consider the prevailing circumstances.

[18] See chapter 7 para 2 4.

whole and as a part of an overall investment strategy. This approach is referred to as the total portfolio approach.[19]

The total portfolio approach contrasts markedly with the isolation approach. The latter approach assesses the decisions of trustees on an investment-by-investment basis. The isolation approach creates the following two problems for trustees: first, it tends to label broad categories of investments and techniques as speculative and thus as imprudent *per se*; and second, because the isolation approach concentrates on single investments without looking at the portfolio in its entirety, trustees are required to defend the performance of each individual investment in the portfolio. This practice exposes trustees to liability for the value of one investment declining even if that investment is part of a well-diversified portfolio.[20]

Jurisdictions such as New York and England have moved from the isolation approach to an approach that evaluates trustees' performance in light of the performance of the entire portfolio, while New Zealand is also in the process of making this shift. Currently, existing law in New Zealand does not go far enough in making the compatibility of the total portfolio approach and trustee investing obvious. The New Zealand Law Commission recommended that reforming legislation ought to require trustees to look at a trust's investment portfolio as an interlocking whole, and not just at its individual elements. Accordingly, the Trusts Act 2019 includes provisions that indicate the acceptance of the total portfolio approach.[21]

2 3 3 The diversification of trust investments

The type of diversification that coincides with MPT is accomplished by finding investments that complement one another and by eliminating unsystematic risk. Two investments complement each other when they are likely to perform well under opposite market conditions or at different times. Adverse movements in one investment will be offset by positive results in the other. By finding investments that have offsetting risks, trustees can theoretically reduce all unsystematic risk in a portfolio. The only risk remaining in a diversified portfolio will be systematic risk. In contrast, there will be systematic and unsystematic risk in a non-diversified portfolio.

[19] See chapter 7 para 3 2.

[20] See chapter 7 para 3 2.

[21] See chapter 7 para 3 4.

Therefore, the risk of a diversified portfolio will typically be lower than that of a non-diversified portfolio.[22]

Choosing investments that have offsetting risks will often lead to trustees having to select investments that are seen as speculative or risky when viewed in isolation. Diversification is thus related to the previous two areas of trustee investing, namely "trustees' choice of investments" and "the evaluation of a trust's investment portfolio". Trustees are better equipped to choose investments with offsetting risks if they are allowed to make any kind of investment and select investments based on their contribution to the overall portfolio.[23]

Importantly, MPT-based diversification permits the risk of a portfolio to be reduced without lowering the portfolio's return expectations. The fact that diversification enables trustees to reduce the risk of a portfolio substantially while keeping expected returns constant makes diversification fundamental to the management of risk.[24]

In response to the lessons of MPT, the need to diversify trust investments has been intensified in the comparable foreign jurisdictions: in New York, trustees have a presumed duty to diversify investments; in England, trustees should explain a lack of diversification satisfactorily; and in New Zealand, diversification is regarded as paramount to the interest of beneficiaries.[25]

2 3 4 Traditional capital and income allocation rules

A key principle of MPT is that it is artificial to distinguish between income and capital when investing. Instead, MPT assesses investment options based on its overall total return regardless of whether the investments are categorised as income or capital.[26]

Traditional capital and income allocation rules do not allow trustees to ignore the distinction between income and capital for purposes of investing. The full integration of MPT into trust investment law results in trustees not being constrained by these allocation rules. Investing without this constraint is known as total return investing. The effect of total return investing reform is that investment decision-making is

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[22] See chapter 7 para 4 2.

[23] See chapter 7 para 4 3.

[24] See chapter 7 para 4 2.

[25] See chapter 7 para 4 4.

[26] See chapter 7 para 5 3.

separated from distributional issues. In other words, trustees do not have to select investments based on the legal category of the returns received. Total return investing thus allows trustees to, as a first step, invest for maximum overall return, and then in a separate and subsequent step, allocate the return as fairly as possible. The promise of total return investing is that, if implemented and administered correctly, it delivers a higher rate of return than an investment strategy that is required to achieve a particular income/capital allocation.[27]

There are three ways of facilitating total return investing in a trustee investment context: the power to access capital, the power of allocation, and percentage trusts.[28] Each of the comparable foreign jurisdictions has a different view regarding which method is the most suitable way of accomplishing total return investing: legislation in New York permits both the use of the power of allocation and the creation of percentage trusts; the English Law Commission considers the percentage trust model as the method most likely to be successful in facilitating total return investment should total return investing be implemented in England; and in New Zealand, the Trusts Act 2019 reflects the New Zealand Law Commission's recommendation that the power of allocation should be the default standard.[29]

2 3 5 Delegation of trustees' investment functions

MPT maintains that people who manage other people's assets but who possess limited investment knowledge should use the skills and judgement of persons with the necessary investment expertise.[30] The full integration of MPT into trust law thus necessitates that non-expert trustees should be allowed to appoint investment experts to make investment decisions.

Trustees in New York and in England are permitted to delegate their investment functions. As a general rule in New Zealand, trustees are not allowed to delegate investment functions to investment managers. However, New Zealand's current

[27] See chapter 7 para 5 3.

[28] See chapter 7 para 5 4

[29] See chapter 7 para 5 5.

[30] See chapter 7 para 6 5.

position will change once the Trusts Act 2019 enters into force, since the Act allows trustees to delegate investment decision-making to investment managers.[31]

2 3 6 Balancing of investment gains against investment losses in the event of a breach of trust

A discussion of this particular area of trustee investment requires giving specific consideration to the application of the anti-netting rule. The anti-netting rule provides that trustees cannot balance a loss arising from a breach of trust against a gain from another breach of trust or against a gain from an investment not involving a breach of trust. An exception to the anti-netting rule is carved out for situations described as "connected breaches of trust". In such cases, the trustees are only accountable for an investment portfolio's net gain or loss.[32]

Some authors and academics criticise the anti-netting rule as being at odds with MPT. More specifically, they argue that that the rule is an uneasy fit with one of the central ideas of MPT, namely the total portfolio approach. Such criticism is, however, without merit. The rule only comes into effect after a breach of trust has occurred and thus has no bearing on gains and losses from ordinary investments where no breach of trust has taken place. The anti-netting rule should, therefore, not be viewed as being in conflict with MPT or the total portfolio approach.[33]

The anti-netting is accepted in its entirety in New York and English trust law. In contrast, legislation in New Zealand is designed to overcome the effect of the anti-netting rule. Exploring the reasons why the position in New Zealand differs from the positions in New York and England is not particularly meaningful since New Zealand's position is derived from an incorrect understanding of the nature and extent of the anti-netting rule. [34]

[31] See chapter 7 para 6 4.

[32] See chapter 7 para 7 2 1.

[33] See chapter 7 para 7 2 4.

[34] See chapter 7 para 7 3.

2 4 Question 4: how should the six particular areas of trustee investment be amended in South African trust law in order to accommodate MPT?

As discussed in chapter 7, it is proposed that South Africa's current rule governing trustees' investment functions, namely the prudent and careful person rule, be replaced with an investment rule based on MPT, namely South Africa's prudent investor rule.[35] Therefore, it is proposed that a new section, section 9A, be inserted in the Trust Property Control Act with the heading "The prudent investor rule".[36]

An important point to highlight is that South Africa's prudent investor rule will only find application when trustees are exercising their investment functions. The current prudent and careful person rule will thus continue to govern all non-investment related functions. Accordingly, no changes to section 9 of the Trust Property Control Act are proposed, save for the section indicating that it is only applicable to non-investment related functions.

The recommendations of how the six particular areas of trustee investment should be amended in South African trust law to accommodate MPT are summarised below. Significantly, the discussion of how these investment areas should change also reveals what the core features of the proposed South Africa's prudent investor rule should be.

2 4 1 Wide investment powers

In South African trust law, not all investments are in principle open to consideration for trustee investment. The rule that governs how trustees should exercise their investment functions is the prudent and careful person rule. In terms of the rule, if trustees receive investments that are speculative, they should sell the investments and reinvest the proceeds in safer investments.[37]

The problem with South African trust law restricting trustees' choice of investments is that it prevents trustees from using investment strategies that offer greater diversification across the investment spectrum and that have the potential to add significantly to the stability and long-term prospects of a trust portfolio.

[35] See chapter 7 paras 1 and 2 5.

[36] For a compilation of the proposed provisions of s 9A, see para 4 below.

[37] See chapter 7 para 2 2.

Consequently, it is proposed that South Africa's prudent investor rule should declare all assets open to consideration for trustee investment.[38]

In order to balance the introduction of wide investment powers, it is further proposed that the newly proposed section 9A should contain the following two safeguards: first, trustees are subject to a statutory duty of care when exercising their powers of investment;[39] and second, trustees are given greater flexibility in choosing investments provided, that the overall investment plan is prudent and that any additional investments advance the overall investment plan.[40]

2 4 2 Total portfolio approach

South African trust law requires trustees' investment decisions to be assessed on an investment-by-investment basis if these decisions are called into question. The isolation approach is thus currently used in South African trust law to evaluate a trust's investment portfolio.[41]

It is proposed that South Africa's prudent investor rule should require trustees to pursue an overall investment strategy in accordance with the level of risk-and-return reasonably suited to the entire trust portfolio. In other words, it is proposed that trustees should follow the total portfolio approach.[42]

In order to determine what would be regarded as a suitable level of risk-and-return, trustees must take the circumstances of each particular case into account. Therefore, it is further proposed that section 9A should list the circumstances that trustees have to consider before making investment decisions.[43]

It is submitted that these two proposals would give concerned trustees the necessary confidence that the total portfolio approach has statutory approval and that the approach would be readily defensible in legal proceedings.

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[38] See sub-s (2) of s 9A.

[39] See sub-s (1) of s 9A.

[40] See sub-s (3) of s 9A.

[41] See chapter 7 para 3 3.

[42] See sub-s (3) of s 9A.

[43] See sub-s (4) of s 9A.

2 4 3 Duty to diversify

There is currently no duty to diversify investments in South African trust law.[44] As discussed in paragraph 2 3 3 above, the benefit of MPT-based diversification is that it enables trustees to reduce the risk of a portfolio substantially while keeping expected returns constant. It is, therefore, proposed that South Africa's prudent investor rule should require trustees to diversify trust investments unless it is not in the interests of the beneficiaries.[45]

Furthermore, it is proposed that trustees should be required to determine whether to sell or retain assets received from a founder.[46] The reason for the latter requirement is to signal a change in law. Beneficiaries, at least in the case of testamentary trusts, are currently entitled to trust assets in the same state in which the assets were received. Considering the benefits of diversification, it is submitted that it is generally more important for trustees to diversify trust investments than to leave investments to the ultimate beneficiaries in the form given by the founder. The only circumstances under which it might be in the interest of beneficiaries that certain types of initial assets be left undisturbed is if the assets of the trust consist of a family company (or farm) or if there is an asset that is not being held for investment (eg a property used for occupation by beneficiaries).[47]

An important question that surrounds the duty to diversify is: when is it in the interest of the beneficiaries not to diversify? Seeing that diversification is paramount to the interest of beneficiaries, it is suggested that a failure to diversify should only be justified in very unusual situations. Therefore, the smallness of a trust fund should not be used as an excuse to restrict diversification. Instead of investing in a small number of investments, trustees could invest in a market index fund. Possible tax costs should also not be used to justify non-diversification. Chapter 7 illustrated that it is safer and more advantageous to sell assets and invest in a diversified portfolio than it is to retain a concentrated position for tax reasons.[48] Finally, when confronted with retention clauses, trustees should meticulously consider whether such clauses

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[44] See chapter 7 para 4 5.

[45] See sub-s (5) of s 9A.

[46] See sub-s (5) of s 9A.

[47] See chapter 7 para 4 7.

[48] See chapter 7 para 4 6 2.

are in the best interest of beneficiaries. Retention provisions can be divided into permissive and mandatory retention provisions. Permissive retention provisions relating to shares in public companies would not be sufficient to protect trustees from a failure to diversify. On the other hand, trustees should be given more leeway not to diversify in circumstances in which a permissive retention provisions relates to a family company (or farm). Although mandatory retention provisions are binding on trustees, there is an exception to the rule. Should trustees find that an asset is deteriorating in value and is expected to keep on deteriorating, and that the decline in value of the asset is owing to circumstances that the founder did not contemplate or foresee, the trustees should apply to the court in terms of section 13 of the Trust Property Control Act for an order to sell the asset.[49]

Finally, it is proposed that trustees should classify a property used for occupation by beneficiaries as "not being held for investment". Consequently, many trust portfolios will consist of an investment portfolio as well as a non-investment component. South Africa's prudent investor rule will govern the investment portfolio, whereas trustees' ordinary standard of care will govern the non-investment component of a trust. This notion of classifying a property as not being held for investment will be introduced into existing legislation by adding the following definition into section 1 of the Trust Property Control Act:

> "Trust investment portfolio means the investment component of the trust and excludes assets in the trust that are not being held for investment."

2 4 4 Total return investing

In South Africa, the combination of the traditional distribution rule and the duty of impartiality limits trustees' ability to invest for total return. As a consequence, it is extremely difficult for trustees to protect the real value of trust capital and produce an adequate income continuously.[50] As discussed in paragraph 2 3 4 above, the solution is total return investing since it significantly increases the chances of a successful outcome for both income and capital beneficiaries.

The only change to legislation required to enable trustees to invest for total return is to disregard the distinction between income and capital. No changes to the duty of

[49] See chapter 7 para 4 6 3.

[50] See chapter 7 para 5 2.

impartiality are thus required. In order to enable trustees to use total return investing, it is proposed that section 9A should give statutory recognition to the power of allocation and make provision for the creation of percentage trusts. It is also proposed that a definition of a percentage trust be added to section 1 of the Trust Property Control Act.

Given the great variety of situations that founders and trustees face, no one method of facilitating total return investing is correct for all circumstances. Accordingly, founders and trustees should be able to choose the option that best suits the circumstances of the particular trust. This raises the following important question: which method of facilitating total return investing is best suited for which type of scenario? After examining four possible trust scenarios, it is concluded that:[51]

(a) Where the income and capital beneficiaries have identical interests, the trustees are automatically capable of investing for total return.

(b) In a discretionary trust where the income and capital beneficiaries have different interests, the most suitable method of facilitating total return investing is the power of allocation.

(c) In a traditional net-income trust where the income and capital beneficiaries have different interests and beneficiaries should be treated impartially, the most suitable way of facilitating total return investing is to convert the trust to a percentage trust.

(d) In a traditional net-income trust where the income and capital beneficiaries have different interests and preferential treatment is required, more flexible methods of facilitating total return investing should be used such as the power to access capital or the power of allocation.

2 4 5 Delegation of investment functions

The default position in South African trust law is that trustees are not entitled to delegate investment functions to someone else. This rule is referred to as the non-delegation rule.[52] The problem with the non-delegation rule is that it prevents trustees

[51] See chapter 7 paras 5 6 and 5 7.

[52] See chapter 7 para 6 2.

from pursuing rewarding investment strategies since non-expert trustees are not permitted to delegate investment functions to someone with investment expertise.[53] Furthermore, should MPT be implemented in South African trust law, the non-delegation rule would prevent trustees from implementing such an investment strategy because the rule would not allow trustees to delegate investment functions to someone with an understanding of MPT.

The proposed solution is to abandon South Africa's non-delegation rule and replace it with a pro-delegation default rule that enables trustees to delegate investment functions to a co-trustee with investment expertise. Notice that the proposed pro-delegation default rule will only allow internal delegation (delegation to a co-trustee) and not external delegation (delegation to a third party). The main concern with delegating investment functions to a third party (eg an outside investment manager) is that an investment manager is not under a fiduciary duty of any kind to trust beneficiaries. Therefore, in order to provide beneficiaries with adequate protection, the proposal is that only delegation to co-trustees should be allowed.[54]

It is further proposed that South Africa's prudent investor rule should provide that as long as the delegation is proper, delegating trustees will not be liable for the wrongful acts of a delegate trustee. Maintaining liability would defeat the purpose of delegation. Delegation will be regarded as proper if delegating trustees comply with the following two legislative safeguards: first, trustees must provide a written policy statement before delegating their investment functions; and second, they must monitor the performance of the delegate trustee.[55] It is also proposed that a definition of a policy statement be added to section 1 of the Trust Property Control Act.

The problem with the non-delegation rule cannot simply be resolved by consulting with experts and acting on their advice. In most cases, relying on advice will amount to *de facto* delegation. Although delegation would thus occur, the necessary safeguards would not be in place. Beneficiaries' interests are not adequately protected if the proper safeguards are not in place.[56]

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[53] See chapter 7 para 6 3.

[54] See chapter 7 para 6 5.

[55] See chapter 7 para 6 5 2.

[56] See chapter 7 para 6 3.

It is submitted that if trustees are authorised to delegate investment functions to a co-trustee who possesses the necessary investment expertise, trustees will be allowed to serve beneficiaries better since it will ensure that persons with the necessary investment expertise and with an understanding of MPT make investment decisions.

2 4 6 Anti-netting rule

The anti-netting rule is only partially accepted in South African trust law. Partial acceptance of the rule means that the second part of the anti-netting rule – the part that deals with a loss carried out in breach of trust netted off against a gain from an investment *not involving a breach of trust* – does not form part of our trust law. The problem with this omission is that it allows delinquent trustees to escape liability if certain parts of a trust's investment portfolio perform well.[57]

In order to discourage trustees from committing breaches of trust, it is proposed that the anti-netting rule should be accepted in its entirety in South African trust law. To be more specific, the proposal is that South Africa's prudent investor rule should contain a complete and comprehensive anti-netting rule similar to the rule found in New York and English law.[58] Such a rule will deter trustees from: committing additional breaches of trust; speculating with certain parts of a trust's investment portfolio; and investing trust property carelessly.[59]

It is also proposed that section 9A of the Trust Property Control Act should give statutory recognition to the anti-netting's rule exception and list the factors that a court could consider in determining whether two breaches are connected.[60] Clear guidelines on what constitutes a connected breach of trust are essential because the guidelines prevent trustees from proving that a connected breach of trust took place in order to reduce or escape their liability.

[57] See chapter 7 para 7 4.

[58] See chapter 7 para 7 4.

[59] See chapter 7 para 7 2 4.

[60] See chapter 7 para 7 5.

3 The main research questions

3 1 Question 1: should trustees' investment functions in South African law be modernised through the implementation of an investment rule based on MPT?

New York, England and New Zealand have embraced the principles of MPT and have integrated these principles into their respective trust laws. South African trust law has not taken advantage of these concepts and is thus largely outdated compared with the laws and practices of the comparable foreign jurisdictions.

Chapters 4 to 7 showed that the introduction of MPT's principles into trust law is a positive development from the perspective of trustees and that beneficiaries can benefit greatly from such development. More specifically, these chapters illustrated that an investment rule based on MPT provides trustees with better guidance in making investment decisions and makes it possible for trustees to protect the real value of trust capital while simultaneously also ensuring that adequate income is produced continuously.

Therefore, the first research question should be answered in the affirmative: trustees' investment functions in South African law should be modernised by implementing an investment rule based on MPT, namely South Africa's prudent investor rule.

3 2 Question 2: what should the core features of an investment rule based on MPT be?

The core features of an investment rule based on MPT correspond to the six areas of trustee investment that are affected most prominently by the introduction of MPT into trust law.[61] Therefore, to answer the second research question, the core features of South Africa's proposed prudent investor rule should be the following: first, the rule should give trustees wide investment powers; second, the rule should require trustees to follow the total portfolio approach; third, the rule should require trustees to diversify trust investments; fourth, the rule should enable trustees to use total return investing; fifth, the rule should allow trustees to delegate investment functions; and sixth, the rule should accept the anti-netting rule.[62]

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[61] See chapter 7 para 7 1.

[62] See chapter 7 paras 7 2 to 7 7.

4 Proposed amendments to the Trust Property Control Act

Based on the analysis conducted in chapter 7, below is a compilation of the proposed provisions of section 9A and the three additions to section 1 of the Trust Property Control Act:

9A The prudent investor rule

(1) In performing his investment related functions, a trustee must exercise the care, diligence and skill that a prudent investor would exercise in similar circumstances.

(2) A trustee may make any kind of investment consistent with the prudent investment standard.

(3) A trustee is required to pursue an overall investment strategy in accordance with the level of risk-and-return reasonably suited to the trust's investment portfolio.

(4) The following circumstances should be taken into consideration in investing and managing trust assets–

(a) the purpose and terms of the trust;

(b) the size of the trust estate;

(c) the estimated duration of the trust;

(d) general economic conditions;

(e) the possible effect of inflation or deflation;

(f) the need to maintain the real value of the capital of the trust and to ensure the production of adequate income;

(g) the expected tax consequences of investment decisions or strategies;

(h) the role that each investment or course of action plays within the overall investment portfolio;

(i) the expected total return of the portfolio (including both income and appreciation of capital);

(j) the needs of the beneficiaries (to the extent reasonably known to the trustees) for present and future distributions;

(k) other resources of the beneficiaries; and

(l) other relevant matters worth considering.

(5) The prudent investor rule requires a trustee to diversify assets unless the trustee reasonably determines that it is in the interest of the beneficiaries not to diversify; and to determine within a reasonable time after the creation of the trustee relationship whether to retain or dispose of initial assets.

(6) For the purposes of distribution and in the absence of any contrary indication in the trust instrument, a trustee may in the trustee's discretion allocate a return on an investment, whether income or capital in nature, either to the income beneficiaries or the capital beneficiaries.

(7) A founder may establish a percentage trust or, absent any contrary indication in the trust instrument, a trustee may convert an existing trust into a percentage trust. Once a percentage trust has been created, a trustee must–

(a) valuate the trust assets at least once every year unless the trust instrument requires more frequent valuations; and

(b) pay the income beneficiaries the percentage rate specified in the trust instrument, or if no percentage is specified, the percentage rate as per the regulations published by Government Notice.

Once a percentage trust has been created, a trustee may–

(a) exclude from calculations trust assets not being held for investment; and

(b) apply the specified percentage rate to the trust assets averaged over a three-year period.

(8) Unless provided for otherwise in a trust instrument, trustees may delegate investment functions to a co-trustee with the necessary investment expertise.

(9) In delegating investment functions under subsection (8), trustees are required to–

(a) provide a written policy statement; and

(b) monitor the performance of the delegate trustee.

(10) Delegating trustees are liable for a loss in the value of trust assets caused by an act or omission of a delegate trustee only if the delegating trustees are in breach of subsection (9).

(11) Losses from a breach of trust cannot be offset by either gains from investments not involving a breach of trust, or gains from other breaches of trust; unless those other breaches are connected.

(12) Whether or not two or more breaches of trust are connected depends on the following factors–

(a) whether the breaches of trust are the result of a single policy, judgement, or set of interrelated decisions;

(b) the length of time that elapsed between the breaches of trust;

(c) whether, between the breaches of trust, the trustees became aware of the earlier breach, and particularly of a resulting loss or profit; and

(d) whether the trustees intended to commit a breach of trust.

Section 1 (definitions):

"percentage trust" means a trust in which all investment gains are initially assigned to trust capital and then at a later stage a percentage of the capital is allocated to income beneficiaries.

"policy statement" means a document that gives a delegate trustee guidance as to how asset management functions should be exercised.

"trust investment portfolio" means the investment component of the trust and excludes assets in the trust that are not being held for investment.

5 Recommendations for further research

5 1 Tax considerations

The actual implementation of South Africa's prudent investor rule requires not only an understanding of MPT and trust law, but also an understanding of tax. The main area that raises questions regarding tax is "total return investing in trusts".[63] Unfortunately, space did not allow for a discussion of the tax considerations of total return investing.

In order to heighten the chances of reform actually being achieved, it is recommended that further research into the tax implications of total return investing should be undertaken. The focus of such research should be on answering the question whether total return investing fits into the current South African tax framework or requires tax reform.

5 2 The trust fund concept

Another interesting topic for further research is the recent scholarship on the character of a common law trust "as a fund". More specifically, it is recommended that the following should be investigated: how the trust fund concept was developed, how the concept was adopted over time and how the concept was influenced by modern financial theories. It is recommended that research on this topic should start with an analysis of Lau's 2013 paper.[64] In the paper, Lau states that:[65]

> "But it was only in the twentieth-century that modern financial theories were impressed upon trust law. Income and capital gain investment preferences were rendered obsolete by modern portfolio theory, emphasizing on total returns. So although Chancery judges did not invent the fund concept, they certainly adopted it, turned it into a legal concept, and perfected it."

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[63] For an explanation of total return investing, see chapter 7 para 5 3.

[64] MW Lau "The nature of the beneficial interest: historical and economic perspectives" (2013) available at: <http://ssrn.com/abstract=2213055> (accessed 14-10-2020). See also, A Braun "The framing of a European law of trusts" in L Smith *The Worlds of the Trust* (2013) 277 290.

[65] 54-55.

Research on this topic could strengthen the arguments in favour of the "total portfolio approach"[66] and the argument to disregard the distinction between income and capital.[67]

5 3 Component duties of trustees' general fiduciary duty

The dissertation only dealt with two of the component duties of trustees' general fiduciary duty, namely the duty of care[68] and the duty of impartiality.[69] Regarding the duty of care, the dissertation addressed the duty mainly within the context of trustees' duty to invest. Although there were fleeting references made to trustees' general duty of care,[70] the duty was mostly discussed within an investment context. Regarding the duty of impartiality, the dissertation only addressed the second element of the duty of impartiality (ie trustees' obligation to treat beneficiaries impartially) and not the first element of the duty of impartiality (ie the duty of trustees to avoid a conflict of interest between their private interests and those of the beneficiaries).[71]

Further research is recommended regarding the origin and content of trustees' general duty of care. Further research could also discuss the origin and content of trustees' other component duties, namely the duty of accountability, the duty of independence and the first element of the duty of impartiality.[72] The aim of such research would be to show how trustees should exercise these duties when investing in accordance with South Africa's prudent investor rule.

[66] For an explanation of the total portfolio approach, see chapter 6 para 3 2.

[67] For an explanation of this argument, see chapter 6 para 4 3.

[68] See chapter 2 paras 2 3 and 2 3 1.

[69] See chapter 7 para 5 2 2.

[70] See chapter 2 para 2 3 and chapter 5 para 2 2.

[71] F du Toit, B Smith & A van der Linde *Fundamentals of South African Trust Law* (2018) 131-133.

[72] F du Toit "The fiduciary office of trustee and the protection of contingent trust beneficiaries" (2007) 3 *Stell LR* 469 474-476; Du Toit et al *South African Trust Law* 99-101.

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